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Piercing the Veil of Limited Liability Companies: The Need for a Better Standard

Jeffrey K. Vandervoort

“If truth were not often suggested by error, if old implements could not be adjusted to new uses, human progress would be slow.”

Oliver Wendell Holmes
The Common Law, 1881¹

I. INTRODUCTION

With the advent of the limited liability company (“LLC”) has come a flurry of changes in tax law, business law, and administrative procedure in an attempt to adapt our system to this new form of entity. From the date of the LLC’s arrival in the United States, changes were necessary due in part to the fact that the LLC is essentially a hybrid, combining characteristics of both partnerships and corporations. As such, the LLC could not be easily categorized by regulators, courts and legislators. The statutory grant of limited liability to an unincorporated entity is one example of how the law has changed. From a tax perspective, in 1996, the Treasury Department and the IRS made a monumental change in issuing the “Check the Box” regulations, effectively giving taxpayers the ability to select the tax treatment for their eligible LLC.

Yet despite the significant changes that have been made to welcome the LLC into the business mainstream, other areas have lagged behind. One such area is the equitable doctrine of piercing the veil of limited liability. Borrowing from the common law of corporations, state legislatures and courts have opted to apply the doctrine of piercing the corporate veil to LLC’s. However, application of the piercing standards to LLC’s has not exactly been smooth sailing. As this article will discuss in greater detail, courts and legislatures have had to consider the fact that some of the traditional veil piercing standards that appear to make sense in the context of corporations, do not make sense in the context of the LLC. For some commentators, this lack of “fit” between the corporate veil piercing standards and the LLC has called the entire system into question.

1. THE QUOTABLE LAWYER, 37 (David S. Shrager & Elizabeth Frost eds., 1986).

In many states, the LLC statutes are fast approaching their ten year anniversary of enactment. Despite this fact, to this date, our judiciary has been given very little guidance as to the proper analysis to apply in assessing a claim to pierce the veil of an LLC. Considering the potentially ruinous implications that veil piercings can have on an individual, the uncertainty in this area appears to be crying out for immediate attention. It has been said before, and I will emphatically repeat it now, this issue is ripe for serious consideration, debate and possible reform.² The time is right for consideration of a new and improved standard for piercing the veil of LLC's, one that is tailored specifically to account for the unique characteristics of the LLC.

Change for the sake of change, however, is not necessarily a good thing.³ Change, especially change in the law, must be made with the goal of advancement of a worthwhile cause and betterment of societal interests. It is our challenge to: (1) reflect on the underlying principles of limited liability; (2) consider the unique characteristics of the LLC; (3) learn from the well-developed body of case law on piercing the corporate veil; and (4) engineer a better standard for assessing claims to pierce the veil of an LLC. In furtherance of these goals, John Matheson ("Matheson") and Richard Eby ("Eby") have proposed a Model Standard ("Matheson-Eby Model Standard") in an effort to start a dialogue on these issues.⁴ This article will discuss the features of the Matheson-Eby Model Standard, analyze its effectiveness, and propose revisions that would improve the standard.

Section II of this article will discuss the principles of limited liability and their impact on this debate. Section III will introduce and briefly discuss the exceptions to limited liability. Section IV will analyze the common law factors used to pierce the veil of corporations. Section V will present a brief history of the limited liability company. Section VI

2. "This desultory state of the common law would itself be reason enough for clarification or reform. Business owners have never had much guidance regarding what activities will result in a loss of limited liability. The stakes are much more significant today, however, as presumptive limited liability for business owners has become the norm through the proliferation of new forms of limited liability entities (LLEs)." John H. Matheson & Raymond B. Eby, *The Doctrine of Piercing the Veil in an Era of Multiple Limited Liability Entities: An Opportunity to Codify the Test For Waiving Owners' Limited-Liability Protection*, 75 WASH. L. REV. 147, 150 (2000). "The veil piercing theory as it has been applied is so seriously flawed that the time has come to reconsider the use of the common law concept at all. It is time for the adoption of a coherent method to deal with the perceived unfairness in risk allocation for all entities with limited liability protection." Rebecca J. Huss, *Revamping Veil Piercing for All Limited Liability Entities: Forcing the Common Law Doctrine into the Statutory Age*, 70 U. CIN. L. REV. 95, 96 (2001).

3. THE QUOTABLE LAWYER, *supra* note 1, at 38 ("Change for the sake of change is not necessarily good. But, change to adapt to the situation is survival.") (quoting *Adapt - or Lose!*, XL Ohio State Bar Association Report 639, 646 (May 22, 1967)).

4. Matheson & Eby, *supra* note 2, at 183.

will discuss the treatment of the piercing issue by various state statutes. Section VII will analyze the application of the corporate veil piercing factors to LLC's. Section VIII will survey recent case law on piercing the LLC veil and develop a few common themes that can be drawn from the cases. Section IX will present the case that a new standard for piercing the veil of LLC's is needed. Section X will introduce and discuss the Model Standard proposed by Matheson and Eby, and then propose revisions to the standard that will make it more effective and perhaps more palatable to critics.

II. LIMITED LIABILITY

The debate over the standards used for piercing the corporate veil has its roots in the policies of a closely related debate. . . that of limited liability.⁵ For the corporate shareholder or member of an LLC, limited liability means that you are not liable for the debts and obligations of the enterprise.⁶ Practically speaking, limited liability refers to the ability of a shareholder or interest holder of an LLC to risk only the capital that such individual invests in the entity.⁷

Limited liability was originally derived, among other things, to encourage economic expansion through investment.⁸ Following the Industrial Revolution, capital-intensive businesses required substantial amounts of capital that regularly exceeded the means of the typical entrepreneur.⁹ One way to fulfill this need was to encourage outside investment. Granting limited liability to those who contributed the capital encouraged such investment, because investors could invest without risking all their personal assets.¹⁰ While investors were often willing to risk their entire net worth to businesses they operated, investors, absent limited liability, were not willing to invest such value in

5. See, e.g. David L. Cohen, *Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company?*, 51 OKLA. L. REV. 427, 429 (1998) ("The history of the firm illustrates the tension between the conflicting goals that American society set for corporations. On the one hand, Americans wished to promote efficient wealth maximization by as broad a range of people as possible. On the other, Americans wanted to regulate the firm in order to protect those who lost out on that wealth creation.").

6. Robert B. Thompson, *The Limits of Liability in the New Limited Liability Entities*, 32 WAKE FOREST L. REV. 1, 7 (1997).

7. Huss, *supra* note 2, at 103.

8. Stephen B. Presser, *Piercing the Corporate Veil* § 1.06 (1993), cited in Eric Fox, *Piercing the Veil of Limited Liability Companies*, 62 GEO. WASH. L. REV. 1143, 1154 (1994).

9. Steven C. Bahls, *Application of Corporate Common Law Doctrines to Limited Liability Companies*, 55 MONT. L. REV. 43, 56 (1994); Matheson & Eby, *supra* note 2, at 155.

10. Bahls, *supra* note 9, at 56.

businesses that they did not operate or closely monitor.¹¹ With limited liability, owners are set free to invest in various business ventures without the need to incur the excessive costs necessary to monitor each enterprise closely.¹²

Further support for limited liability based on economic principles can be found in the work of Frank H. Easterbrook ("Easterbrook") and Daniel R. Fischel ("Fischel"). In their often-cited book, *The Economic Structure of Corporate Law*, Easterbrook and Fischel advance the theory that limited liability reduces the transaction costs that arise due to the separation of agents and owners of capital and it enhances the efficient and smooth running of the securities markets.¹³ This results in a lower cost of capital, which leads to increased economic output and advancement of the public welfare.¹⁴ The authors offer six reasons in support of their theory: (1) limited liability reduces the entity's and its shareholders' need to monitor its agents, which makes passive investing and diversification a more rational strategy, reducing the costs of operating the entity;¹⁵ (2) limited liability reduces the need to monitor other shareholders to see whether they can properly bear the risks that the entity plans or is undertaking;¹⁶ (3) limited liability promotes the free transfer of shares, which creates incentives for managers to act efficiently since the results of their inefficient actions will be punished by the market;¹⁷ (4) limited liability makes shares homogenous commodities that reflect all the information publicly available about the entity, allowing trading on the same terms and ensuring investors that the price reflects all available information;¹⁸ (5) limited liability allows for more efficient diversification of one's assets;¹⁹ and (6) limited liability prevents managers from becoming unduly risk averse.²⁰ As can be drawn from these six examples, the key economic justification for limited liability is based on the premise that apart from the simple shifting of loss from interest holders to

11. *Id.*

12. *Id.*

13. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 4, 40-59 (1991), *quoted in* Cohen, *supra* note 5, at 438.

14. *Id.*

15. EASTERBROOK & FISCHEL, *supra* note 13, at 41-42, *quoted in* Cohen, *supra* note 5, at 438.

16. EASTERBROOK & FISCHEL, *supra* note 13, at 41-42, *quoted in* Cohen, *supra* note 5, at 438-39.

17. EASTERBROOK & FISCHEL, *supra* note 13, at 42-43, *quoted in* Cohen, *supra* note 5, at 439.

18. EASTERBROOK & FISCHEL, *supra* note 13, at 43, *quoted in* Cohen, *supra* note 5, at 438.

19. *Id.*

20. EASTERBROOK & FISCHEL, *supra* note 13, at 44, *quoted in* Cohen, *supra* note 5, at 439.

creditors, there is a change in behavior due to the limited liability status of interest holders.²¹

In addition to the facilitation of capital investment and economic efficiency, limited liability was favored for its ability to provide democratic access to capital and investment.²² As one observer noted: “[p]rior to limited liability, only the wealthiest investors could afford the risk of personal liability.”²³ Once armed with the protection limited liability offered against personal liability, less affluent investors were able to participate in the market.²⁴

With the growing popularity of limited liability, competition among states soon took over as the main motivating factor behind new legislation. Starting as early as the 1800's, and continuing on to this day, lawmakers have argued that a state's failure to grant limited liability to business owners would drive capital investment to other states.²⁵

Limited liability, however, has not come about without its share of critics. One commentator described limited liability as a tale of two conflicting goals.²⁶ On the one hand, Americans sought to promote efficient wealth maximization by as broad a range of people as possible.²⁷ On the other hand, Americans wanted to regulate the business enterprise in order to protect those who lost out on that wealth creation.²⁸ Historically, Americans have been suspicious of large and powerful corporations and, despite the many highly proclaimed benefits of the corporation, Americans have never quite overcome the early and strong suspicion of corporations as hard-to-control entities that are dangerous to the general public.²⁹ This sentiment can be seen in the words of Thomas Cooper, in the 1800's, who described limited liability as a “mode of swindling, quite common and honorable in these United States” and “a fraud on the honest and confiding part of the public.”³⁰ Today, however, much of the criticism of limited liability focuses on the concern that the liability protection creates a greater incentive for managers of firms to engage in risky behavior.³¹ Critics

21. EASTERBROOK & FISCHER, *supra* note 13, at 45.

22. Presser, *supra* note 8, § 1.06.

23. Presser, *supra* note 8, § 1.03[1].

24. *Id.*; Cohen, *supra* note 5, at 438; Huss, *supra* note 2, at 104.

25. See HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW, 1836-1937, 50 (1991), *quoted in* Bahls, *supra* note 9, at 55.

26. Cohen, *supra* note 5, at 430.

27. *Id.*

28. *Id.*

29. *Id.* at 428.

30. HOVENKAMP, *supra* note 25, at 50 (quoting THOMAS COOPER, LECTURES ON THE ELEMENTS OF POLITICAL ECONOMY 247-50 (2d ed. 1830)) (footnote omitted).

31. See EASTERBROOK & FISCHER, *supra* note 13, at 58, *quoted in* Cohen *supra* note 5, at 441.

caution that managers of a limited liability firm, knowing that the burden of risk will fall elsewhere, will engage in overly risky endeavors.³² Nevertheless, based on a weighing of interests, legislators have repeatedly decided to accept these risks in order to reap the benefits of increased capital investment and economic efficiency. As this article moves into a discussion of the underlying policies of the doctrine of piercing the corporate veil, many of these themes will resurface.

III. COMMON LAW EXCEPTIONS TO LIMITED LIABILITY

A. *Personal Conduct*

Notwithstanding the statutory grant of limited liability to corporate shareholders and LLC members, state common law has maintained several important exceptions. First, regardless of a person's status as a shareholder or member of an LLC, that person cannot escape liability for his own personal conduct.³³ In the case of a tort, if a member of an LLC commits a tort while in the course of LLC business, that person can be held personally liable for that tort.³⁴ Hence, the limited liability shield provided by the LLC statute will not protect that person from personal liability for his own acts. Individuals acting for LLC's or corporations can also expect to be held personally liable for criminal or otherwise wrongful conduct.³⁵

B. *Agency or Collective Torts*

Under agency principles, a shareholder or LLC member may become personally liable for tort claims as a result of his or her own negligence in appointing, supervising, or participating in the activity in question with a manager, employee, agent or other member of the corporation or LLC.³⁶ Under a similar concept known as the collective torts doctrine, tort victims may personally sue those individuals in a business who can be identified as the central decision-makers in the actionable conduct.³⁷ Once identified, the central decision-makers can be held personally liable for their tortious conduct.³⁸ While this theory of liability may be difficult if not impossible to prove in a large

32. See EASTERBROOK & FISCHEL, *supra* note 13, at 50, *quoted in* Cohen, *supra* note 5, at 439-40.

33. Karin Schwindt, *Limited Liability Companies: Issues in Member Liability*, 44 UCLA L. REV. 1541, 1548 (1997).

34. *Id.*; see also J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, *LIMITED LIABILITY COMPANIES: A STATE BY STATE GUIDE TO LAW AND PRACTICE* 42-43 (1994).

35. See Thompson, *supra* note 6, at 11.

36. See Bahls, *supra* note 9, at 59-60.

37. See Schwindt, *supra* note 33, at 1548.

38. *Id.*

corporation, where it may not be feasible to single out responsible individuals, the doctrine may be more of an issue for small, closely held corporations and LLC's.³⁹

C. *Personal Guarantee*

Shareholders and LLC members must be aware of potential contractual liability as well. While an LLC member will generally not be held personally liable for contracts made on behalf of the LLC, a member can become personally liable if they personally guarantee an LLC obligation.⁴⁰ With small, closely held start up companies, lending institutions and suppliers will often require a personal guarantee until a credit history is established or valuable assets are accumulated.⁴¹ Because of this marketplace reality, LLC members who provide personal guarantees may find themselves personally liable for the obligations of the LLC.

D. *Piercing the Corporate Veil*

Finally, there is the doctrine known as piercing the corporate veil. This doctrine comes from traditional principles of corporate common law. The "corporate veil" is a metaphorical reference to the limited liability of a corporation, based on the prevailing rule that when corporate formalities are observed, initial financing is adequate, and the corporation is not formed to defraud creditors or other third parties, the corporate form will be respected and shareholders will not be liable for corporate debts and liabilities.⁴² Under the piercing principles, which are based in equity, the corporate veil will be pierced and the entity disregarded when the corporation is used as a vehicle to "defeat public convenience, justify wrong, protect fraud or defend crime."⁴³ The veil piercing doctrine is based on the recognition that rigid adherence to shareholder limited liability will sometimes lead to unjust out-

39. *See id.* at 1549 ("In a large corporation, it is nearly impossible to identify a single individual or group of individuals responsible for a tort. For example, it would not be unusual for hundreds of people to be involved in the design, production and marketing of a product. However, because LLCs tend to attract small, closely held enterprises run by their members, members are at risk of being held personally liable under the collective torts doctrine. Such enterprises tend to have small numbers of employees, and owners are often involved in operations. Responsibility, though diffuse, may still be confined enough to identify someone as a central figure. An active LLC member may therefore find herself liable for the torts she helps the LLC to commit.").

40. *See id.*

41. *See id.*

42. *See id.* at 1550.

43. Fox, *supra* note 8, at 1154 (quoting *United States v. Milwaukee Refrigerator Transit Co.*, 142 F. 247, 255 (C.C.E.D. Wis. 1905)).

comes.⁴⁴ As a consequence of a piercing, courts will disregard the corporation's limited liability and impose liability for corporate debts on the corporate shareholders.⁴⁵

E. *Applicability to LLC's*

With little difficulty, courts and commentators have seen fit to apply the first three common law exceptions (personal conduct, agency or collective torts, and personal guarantees) directly to limited liability companies. This smooth transition can be credited to the fact that the principles behind the exceptions, as they apply to corporations, for the most part apply equally to LLC's. Individuals will not be protected from the consequences of their own misconduct, or those of their agents, solely because they happen to be shareholders or LLC members.

In comparison, the transition of the principles of piercing the corporate veil from the corporation to the LLC has been anything but smooth. Commentators have raised a number of important issues and areas of concern that call into question the merits behind directly applying the corporate piercing standards to LLC's. The debate is no doubt complicated by the fact that despite years of litigation and commentary, no clear standard has emerged for piercing the veil of corporations. Accordingly, it should come as no surprise that the transition of a vague, mysterious, unsettled doctrine to a new application, involving a variety of new principles and circumstances, would not constitute a solid foundation upon which to build a clear, logical, principled standard to apply to LLC's.

Many of these issues will be summarized in the sections that follow. First, however, this article will take a closer look at the general criteria of the corporate piercing standard.

IV. FACTORS USED TO PIERCE THE VEIL OF CORPORATIONS

Despite many years of case law involving one of the most frequently litigated issues in corporate law,⁴⁶ no concrete, universal formula has emerged under which a court must decide whether or not to pierce the corporate veil and assign personal liability.⁴⁷ The classic test for piercing the corporate veil was promulgated by Fredrick J. Powell. The

44. See Fox, *supra* note 8, at 1154.

45. *Id.*

46. See F. HODGE O'NEAL & ROBERT B. THOMPSON, CLOSE CORPORATIONS § 1.10, at 1-46 (3d ed. 1992), *quoted in* Bahls, *supra* note 9, at 61.

47. "[Judge Frank Easterbrook and Professor Daniel Fischel] note that the doctrine is among the most confusing in corporate law. Likewise, the Montana Supreme Court has noted that

Powell test provides that courts should pierce the corporate veil and impose personal liability when: (1) there is a unity of interest between the corporation and its owners; (2) the corporation's actions are wrongful or fraudulent; and (3) the corporation's creditors suffer an unjust cost which warrants disregarding the corporate form.⁴⁸

In addition to the Powell standard, certain factors have emerged over time to aid courts in their piercing decision.⁴⁹ Four factors that courts have consistently considered in making a piercing determination include: (1) fraud; (2) failure to adhere to corporate formalities; (3) inadequate capitalization; and (4) abuse of the corporate entity so as to amount to complete dominance by the shareholder or shareholders, commonly referred to as the "alter ego" or "instrumentality" factor.⁵⁰

A. *Fraud*

One area of the piercing doctrine where courts have shown relative consistency is with fraud. It is common for courts to pierce the limited liability shield if the corporation has been used to perpetuate a fraud or if a failure to pierce would promote injustice.⁵¹ As a piercing factor, fraud has been left generally undefined and unrestricted by the courts; nevertheless, a few generalizations have been made.⁵² In fraud cases involving contract claims, the following three representations appear to be most common: (1) representations of the entity's financial status; (2) representations relating to the entity's performance; and (3) representations that someone besides the entity will stand behind the debt.⁵³

B. *Corporate Formalities*

Another factor courts have commonly considered in corporate veil-piercing cases is the failure to adhere to corporate formalities.⁵⁴ In

'because the remedy is equitable, no concrete formula exists under which a court will disregard the separate identity of the corporate entity.'" Bahls, *supra* note 9, at 61.

48. See FREDERICK J. POWELL, PARENT AND SUBSIDIARY CORPORATIONS: LIABILITY OF A PARENT CORPORATION FOR THE OBLIGATIONS OF ITS SUBSIDIARY § 3, at 4-6 (1931), quoted in Debra Cohen-Whelan, *Individual Responsibility in the Wake of Limited Liability*, 32 U.S.F.L. REV. 335, 347 (1998).

49. See Fox, *supra* note 8, at 1155.

50. See *id.*

51. See Huss, *supra* note 2, at 112.

52. See *id.* ("The types of actions or behaviors that constitute fraud are not generally defined by the courts, although certain types of representations appear to arise frequently in piercing cases involving contract claims.")

53. *Id.*

54. See, e.g., Fox, *supra* note 8, at 1162.

determining whether to pierce the corporate veil, courts will frequently look first at whether the corporation followed formalities and kept sufficient records of the corporate activity.⁵⁵ Some examples of formalities that courts regularly consider include the duties to: (1) hold annual meetings; (2) elect directors and officers; (3) maintain minutes and corporate records; and (4) issue stock certificates.⁵⁶ Significant lapses in compliance with corporate formalities will weigh against a shareholder maintaining his or her limited liability.⁵⁷

More than any other factor in the corporate veil piercing analysis, adherence to corporate formality has been under fire from critics who question its appropriateness and value as a piercing consideration.⁵⁸ One argument offered in favor of considering formalities is that record-keeping and related formalities assist in determining the conduct of shareholders and the corporation at the time the cause of action arose.⁵⁹ Critics are quick to point out, however, that there is rarely a direct connection between the misconduct (lack of corporate formality or record-keeping, for example), and the creditor's claim.⁶⁰ In addition, critics note that corporate formalities were designed and implemented to protect shareholders from abuse, not to protect third party creditors.⁶¹

Notwithstanding the merits of both sides of the issue, adherence to corporate formality is generally considered insufficient grounds, in and of itself, to justify a piercing.⁶² Instead, it is more commonly cited as a supporting factor for piercing a corporation.⁶³ As explained by David L. Cohen, "[o]ne possible reason is that evidence of the disregard of formalities is usually sought long after the transaction giving

55. See Huss, *supra* note 2, at 112-13.

56. See Fox, *supra* note 8, at 1162.

57. See *id.* ("Failure to comply with corporate formalities usually will weigh against a shareholder seeking to maintain his limited liability.").

58. See, e.g., Fox, *supra* note 8, at 1162 ("Scholars have criticized the use of the failure to follow corporate formalities as a justification to pierce the veil. Unlike capitalization, corporate formalities usually have no relation to the creditors' claims."); Huss, *supra* note 2, at 113 ("Critics say that it is inappropriate for courts to use this factor to pierce the veil in the corporate context because there is no connection between the conduct (failure to keep records) and the wrong leading to the piercing."); Chad Brigham, *Just How Limited is the Illinois Limited Liability Company?* 26 S. ILL. U. L.J. 53, 75 (2001) ("...many scholars and commentators have criticized this factor in holding shareholders personally liable for the debts of the corporation.").

59. See Huss, *supra* note 2, at 113.

60. See, e.g., Fox, *supra* note 8, at 1162-63; Huss, *supra* note 2, at 113.

61. Matheson & Eby, *supra* note 2, at 172-76 ("...the corporate formalities relied upon by courts to disregard limited liability are not intended to protect creditors in the first place. ...[Corporate procedures] are designed to protect shareholders from unfair treatment by the directors or fellow owners.").

62. See Cohen, *supra* note 5, at 456; Cohen-Whelan, *supra* note 48, at 358.

63. See Cohen-Whelan, *supra* note 48, at 358.

rise to the particular lawsuit took place, and a judgment based on activities unrelated to the plaintiff's claim is seen as an unjustified windfall."⁶⁴

C. Undercapitalization

Courts have also considered the undercapitalization of a corporation as an important element of their piercing analysis. Corporate norms and social policy mandate that a corporation contribute enough capital to its business to do a reasonably adequate job in covering its potential liabilities.⁶⁵ As Stephen B. Presser aptly noted:

The basic idea behind the [undercapitalization] theory is that if the shareholder or shareholders deliberately incorporate with initial capital they know to be inadequate to meet the expected liabilities of the business they intend to be doing, they are engaging in an abuse of the corporate form, and ought to be individually liable when those liabilities actually occur.⁶⁶

The amount of capital that is considered "adequate" for any given corporation is dependent upon the nature of the corporate undertaking,⁶⁷ and "[i]f the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege."⁶⁸

Proponents of the undercapitalization factor argue that it would be inequitable to allow shareholders to deliberately or recklessly set up flimsy organizations for the purpose of escaping liability.⁶⁹ In addition, commentators assert that by imposing liability on shareholders, investors will be discouraged from forming risky businesses unless or until they can adequately capitalize or insure their business.⁷⁰ Critics of undercapitalization argue that it should not be a factor in contract cases, where a creditor has the opportunity to investigate the other

64. Cohen, *supra* note 5, at 456.

65. See Schwindt, *supra* note 33, at 1563.

66. Stephen B. Presser, *Thwarting The Killing Of The Corporation: Limited Liability, Democracy, and Economics*, 87 Nw. U. L. REV. 148, 165 (1992).

67. See Fox, *supra* note 8, at 1157 ("Whether a corporation's capital is adequate is a factual issue and depends largely on the nature of the business in comparison with the risk of loss or liability. For example, a corporation formed with no assets to operate a swimming pool service might be susceptible to veil piercing because that business carries an inherent risk of tort liability. This factor is less important if the plaintiff is a contract creditor who has the capacity to determine the corporation's capitalization before conducting business and can require shareholder liability through individual guarantees.").

68. *Mull v. Colt Co.*, 31 F.R.D. 154, 163 (S.D.N.Y. 1962).

69. Schwindt, *supra* note 33, at 1563. Schwindt also points out that "[t]he expectation of capitalization exists at the corporation's inception, and continues throughout the corporation's operation." *Id.*

70. See Fox, *supra* note 8, at 1158.

party and/or contractually protect themselves.⁷¹ Although most courts agree that undercapitalization will weigh in favor of piercing the corporate veil, there is substantial disagreement as to the weight to be given this factor and whether or not it is sufficient cause to justify a piercing by itself.⁷²

D. *Alter Ego or Instrumentality*

One final factor that is commonly considered in piercing cases tests the degree to which the corporation is controlled by the owner or owners.⁷³ This factor is referred to by various descriptive names, including alter ego, instrumentality, disregard of separateness, etc. In order to justify a piercing, courts require a threshold of similarity in interest such that the corporation no longer has a personality separate from its owners.⁷⁴ In an effort to describe the standard, one court noted that a corporation becomes an alter ego or mere instrumentality of the individual "if the individual controls the corporation and conducts its business affairs without due regard for the separate corporate nature of the business; . . . or if the corporate assets are dealt with by the individual as if owned by the individual. . . ."⁷⁵

The underlying policies from which the alter ego doctrine was derived seek to maintain a certain degree of separation of management from ownership.⁷⁶ These policies rationalize that while the passive investor, who has little influence over the actions of a corporation, is justifiably protected from the debts of the corporation, the investor who exerts total control over a corporation should in all fairness be held responsible for the debts he incurs.⁷⁷

In recent years, commentators have taken notice that the alter ego standard affects some types of entities differently than others. As exhibited by the empirical data of Robert Thompson, the alter ego doctrine has had a disproportionate impact on the close corporation.⁷⁸ By definition, close corporations invite piercing since they are formed

71. See Schwindt, *supra* note 33, at 1564.

72. See Fox, *supra* note 8, at 1158.

73. See *id.* at 1163.

74. See *id.* at 1164.

75. *Castleberry v. Branscum*, 721 S.W.2d 270, 275 (Tex. 1986).

76. See Fox, *supra* note 8, at 1166.

77. *Id.*

78. See *id.* at 1164; Thompson, *supra* note 6, at 9 ("Analysis of the hundreds of cases in which piercing has occurred suggests the following results. Piercing occurs only in close corporations or corporate groups; it does not occur in publicly held corporations. . . . In an earlier empirical study, I reported that among the 1600 reported cases of piercing the veil, there was no case in which shareholders of a publicly held corporation were held liable. After additional analysis of that data base, I can make a broader statement. Piercing occurs only within corporate groups or

to conduct business on a more personal level than publicly traded corporations.⁷⁹ As one might surmise, the alter ego doctrine, with its focus on "control", is the major reason close corporations are the primary focus of veil-piercing litigation.⁸⁰

To a lesser degree, the risk of alter ego piercing also exists in a parent corporation's relationship to a subsidiary.⁸¹ In the case of the parent-subsidiary relationship, however, the risk of piercing can be more naturally averted by taking measures to assure corporate formality and respect for the separate entities.⁸² In comparison, with close corporations, the central reasons for forming a close corporation (generally ease and simplicity of corporate governance) encourage a shareholder to run afoul of the standard courts use to justify a piercing of the veil.

V. BRIEF HISTORY OF LIMITED LIABILITY COMPANIES

As one of the more recent additions to the healthy assortment of limited liability entities in the United States, the limited liability company ("LLC") has shown great promise as a choice of entity for today's business enterprise. By offering the limited liability of a corporation, combined with the pass-through tax treatment found in a partnership, the LLC caused a minor business revolution. The LLC became the fastest growing form of business entity.⁸³

Limited liability companies were officially introduced in the United States in Wyoming in 1977, with Wyoming's passage of the first modern LLC act.⁸⁴ The Wyoming LLC legislation was passed in an effort to solve the limited liability/double taxation conundrum of the traditional corporation.⁸⁵ Florida followed Wyoming's lead with LLC leg-

in close corporations with fewer than ten shareholders. None of the close corporations in which piercing occurred had more than nine shareholders.").

79. See Fox, *supra* note 8, at 1164.

80. See *id.*

81. See *id.* at 1164-65.

82. See *id.* at 1165-66 ("[T]he alter-ego doctrine may offer the strongest support for continued use of the corporate-formalities factor. A sole shareholder who also serves as the sole operator of a corporation often fails to follow formalities because the corporation essentially is used as an individual proprietorship. This does not mean, however, that a concentration of ownership in a close corporation is a sufficient reason to pierce the veil. A sole shareholder can enjoy limited liability as long as the business is conducted on a corporate basis rather than on a personal basis and there is adequate capitalization.").

83. See Matheson & Eby, *supra* note 2, at 163-67; see also Warren H. Johnson, *Limited Liability Companies (LLC): Is the LLC Liability Shield Holding Up Under Judicial Scrutiny?*, 35 NEW ENG. L. REV. 177, 185 (2000) ("[t]he number of LLC filings soared such that over 161,000 LLC's were formed by the end of 1995").

84. See Matheson & Eby, *supra* note 2, at 163-64.

85. See *id.* at 163.

islation in 1982. Following the adoption of Wyoming and Florida statutes, however, very little was heard from the LLC for several years.⁸⁶ Uncertainty surrounding the IRS's view of the taxation of the LLC impeded the LLC's growth in popularity.⁸⁷

Then, in 1988, the IRS resolved much of the remaining concern about the LLC by issuing IRS Revenue Ruling 88-76.⁸⁸ The IRS declared that the Wyoming LLC would be taxed as a partnership, with its pass-through single layer of taxation, rather than the double-layer of tax suffered by the corporation.⁸⁹ As a result, beginning in 1990 with Colorado and Kansas, the remaining states began enacting their own LLC statutes.⁹⁰ In 1996, Vermont and Hawaii became the final two states to enact LLC statutes.⁹¹

Even with the issuance of Revenue Ruling 88-76 in 1988, LLC's continued to be hampered by the risk of unfavorable corporate tax treatment by the IRS.⁹² Until 1996, the IRS would decide whether to impose a double tax on an LLC on the basis of the organizational characteristics of the particular business.⁹³ Under treasury regulations adopted in 1960, the IRS used four attributes or characteristics to determine whether a business would be treated as a partnership or corporation for federal income tax purposes.⁹⁴ Known as the Kintner factors, these attributes were: (1) continuity of life; (2) centralized management; (3) limited liability; and (4) free transferability of interests.⁹⁵ In order to avoid being treated as a corporation, and consequently suffering a double layer of tax, an LLC could have no more than two of the Kintner attributes. This four-factor corporate-characteristic standard impeded the progress of LLC development. By unnecessarily complicating the LLC formation process, the Kintner factors inspired alternative forms of business entities and fueled the adoption of new business entity organization laws that sought to limit liability while avoiding double taxation.⁹⁶

86. See Johnson, *supra* note 83, at 184-85 ("[I]t would take several years before the Internal Revenue Service (IRS) would warm up to the LLC concept of corporate-like characteristics with partnership like taxation.").

87. See *id.*

88. See *id.* at 184.

89. *Id.*

90. *Id.* at 184-85.

91. *Id.* at 185.

92. See, e.g., Matheson & Eby, *supra* note 2, at 157-60 (discussing the tax treatment of LLC's prior to the check-the-box regulations).

93. *Id.* at 158.

94. See *id.*

95. See *id.*

96. See *id.* at 158-59.

Fortunately, in 1996, the IRS issued final regulations designed to simplify the tax rules by allowing taxpayers to treat unincorporated business organizations, like the LLC, as a partnership or a corporation on an elective "check the box" basis.⁹⁷ This concession by the IRS helped the LLC gain further momentum by adding to the list of advantages held by the LLC over other business entities.

VI. TREATMENT OF THE PIERCING ISSUE IN LLC STATUTES

Although certainly relevant to this discussion, state limited liability company statutes contribute little in terms of guidance on the piercing issue. In terms of providing limited liability, the LLC statutes are consistent. All LLC statutes set forth the basic premise that LLC's are independent entities that shield their members from personal liability.⁹⁸ In comparison, the LLC statutes are relatively scattered in terms of treatment of the piercing issue. Generally, the states' statutory treatment of the piercing issue can be broken down into three categories: (1) explicit treatment; (2) implicit treatment; and (3) no treatment. In addition, some states have elected to provide for explicit treatment of a particular piercing factor.

A. *Explicit Treatment*

Several states have chosen to explicitly adopt and apply the corporate concept of piercing the veil to their LLC's. For example, Minnesota's LLC statute provides that "case law that states the conditions and circumstances under which the veil of a corporation may be pierced under Minnesota law also applies to limited liability companies."⁹⁹ Similarly, the Colorado LLC statute states:

In any case in which a party seeks to hold the members of a limited liability company personally responsible for the alleged improper actions of the limited liability company, the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law.¹⁰⁰

Statutes like Colorado's and Minnesota's proscribe that the piercing concept shall apply to LLC's and that courts should reference and apply existing corporate case law when making piercing decisions.

97. See generally Simplification of Entity Classification Rules, 61 Fed. Reg. 66, 584 (Dec. 18, 1996); Matheson & Eby, *supra* note 2, at 169.

98. See Schwindt, *supra* note 33, at 1553.

99. MINN. STAT. ANN. § 322B.303(2) (West 2001). For other similar state statutes, see Schwindt, *supra* note 33, at 1553 n.55, (noting that Maine, North Dakota, Tennessee, Washington, and Wisconsin statutes contain similar treatment).

100. COLO. REV. STAT. ANN. § 7-80-107(1) (West 2004).

B. *Implicit Treatment*

Other states have opted for a more subtle approach, but have nonetheless achieved the same result. One such approach is to correlate the liability of members to the liability shield enjoyed by shareholders. For example, Maine's LLC statute provides that the exceptions to limited liability applicable to corporate shareholders also apply to members of limited liability companies.¹⁰¹ In addition, the Illinois statute states: "[a] member of a limited liability company shall be personally liable for any act, debt, obligation, or liability of the limited liability company or another member or manager to the extent that a shareholder of an Illinois business corporation is liable in analogous circumstances under Illinois law."¹⁰² As shown, these statutes make the clear implication that an LLC member, much like a shareholder, can be subjected to veil piercing and thereby exposed to personal liability.

C. *No Treatment*

The third category of state LLC statutes are silent on the issue of piercing the veil. They neither explicitly nor implicitly broach the subject of piercing the veil of the LLC. Examples of state statutes which are silent on the piercing issue include: Ohio, New York, North Carolina and Kentucky.¹⁰³ In the absence of legislative history on the subject, it is difficult to ascertain the true meaning of the omission. Perhaps the most reasonable argument, however, is that these states intended to defer to the courts to develop a common law doctrine for LLC piercing in the same fashion as the corporate veil piercing standards were developed.¹⁰⁴

D. *Special Treatment of Particular Piercing Factors*

Some states have elected to combine references to the corporate liability shield, while at the same time making particular reference to a particular piercing factor. The California statute, for example, states that LLC members will be held liable "under the same or similar circumstances and to the same extent as a shareholder of a corporation may be personally liable. . . except that the failure to hold meetings of members or managers or the failure to observe formalities pertaining to the calling or conduct of meetings shall not be considered a factor

101. 31 ME. REV. STAT. ANN. tit. 31 § 645(3) (West 2004).

102. 805 ILL. COMP. STAT. ANN. 180/10-10(a) (West 2001).

103. See Schwindt, *supra* note 33, at 1554 n.60.

104. *Id.* at 1555.

tending to establish. . . liability.”¹⁰⁵ By adopting the corporate standards for piercing the veil, yet specifically eliminating the corporate formality factor, California went further than any other state in providing guidance as to when piercing is appropriate.¹⁰⁶

VII. APPLICATION OF THE CORPORATE PIERCING FACTORS TO THE LLC

From the enactment of the first LLC statute, the question of piercing has been an ongoing debate. The initial adoption of the corporate standards for piercing the LLC veil was a logical choice considering the fact that piercing is grounded in corporate principles and there is a well-developed body of case law on corporate piercing. It would also seem fair to conclude that the principles for piercing one limited liability entity should be equally applicable and easily transferable to any other limited liability entity. Unfortunately, as shown in the following section, the factors used for piercing the veil of the corporation do not translate well to the LLC.

A. *Adherence to Formalities*

From the early days of the LLC, commentators have overwhelmingly agreed that application of the corporate formality standard to LLC's is problematic at best.¹⁰⁷ To start with, it bears mentioning that the corporate formality standard is highly criticized even as a factor for piercing the veil of corporations.¹⁰⁸ In general, commentators have challenged the relevance of corporate formality to the piercing equation. For example, some argue that statutory corporate formalities were intended to protect participants within the corporate enterprise from surprise decisions or actions without consultation.¹⁰⁹ Protection of third party claimants was not one of the main underlying concerns. While lack of formality claims are a popular challenge to

105. CAL. CORP. CODE § 17101(b) (West 2004); *see also* WASH. REV. CODE ANN. § 25.15.060 (West 2001).

106. *See* Schwindt, *supra* note 33, at 1555.

107. *See, e.g.,* Fox, *supra* note 8, at 1172 (“Many commentators contend that the formalities factor in corporate veil piercing is not appropriate for LLC veil piercing. In the corporate context, the formalities factor is held in low esteem. Commentators are thus willing to disregard this factor in the LLC context.”); Matheson & Eby, *supra* note 2, at 176 (“The failure of these owners to abide by sometimes expensive, often unproductive, formalities is not good evidence of misuse of a limited-liability statute intended to encourage business.”); Cohen, *supra* note 5, at 456-57; Schwindt, *supra* note 33, at 1560-61.

108. *See* Brigham, *supra* note 58, at 74 n.131 (“Many commentators have expressed the same concerns that formalities are too slender a reed to find shareholders, or members for that matter, personally liable for company debts.”) (citations omitted).

109. Matheson & Eby, *supra* note 2, at 174.

the corporate veil, the actual formality lapses are rarely relevant to a plaintiff's injuries in a given case.¹¹⁰ In addition, commentators have noted the irony in the fact that the statutory formalities provided for the owners' protection have evolved into the essential instrument used to strip them of their limited liability.¹¹¹

Notably, several of the arguments used to support the corporate formalities factor are inherently false.¹¹² For example, there is the argument that the LLC owner's failure to comply with statutory formalities indicates the owner's lack of respect for the separateness of the entity from the individual.¹¹³ According to Matheson and Eby, this assumption is both false and irrelevant:

[I]n large part, this result occurs because the same [LLC's] are most often the [small, closely held businesses] in which the owners are most overworked, most likely to overlook formalities irrelevant to their actual operation of the business, and least able to pay an attorney to keep track of their formal statutory obligations. The failure of these owners to abide by sometimes expensive, often unproductive, formalities is not good evidence of misuse of a limited liability statute intended to encourage business.¹¹⁴

Another problem with the adherence to formality factor involves a distinguishing characteristic of LLC's.¹¹⁵ In stark contrast to corporations, LLC's have relatively few statutorily mandated formalities and have a considerable amount of freedom and flexibility as to the management structure of the entity.¹¹⁶ As one commentator pointed out: "LLC members, by the nature of the entity, will be inclined to organize and run LLC's in a very informal manner. . . Thus, to allow piercing for disregarding LLC formalities. . . will make the promise of limited liability for LLC's empty by definition."¹¹⁷ Moreover, strict application of the formalities test could lead to the imposition of additional common law requirements to operate with corporate-like formality.¹¹⁸ This result would be in direct conflict with the legislative

110. *Id.* at 174-75.

111. *See id.* at 175 ("Indeed, it is strange that statutory protections for owners have evolved into an essential instrument used for stripping them of their statutory limited liability.").

112. *See, e.g.,* Matheson & Eby, *supra* note 2, at 175-77.

113. *Id.* at 175.

114. *Id.* at 176.

115. *See* Huss, *supra* note 2, at 112-13.

116. *See id.* at 113.

117. *See* Cohen, *supra* note 5, at 456-57.

118. *See* Cohen-Whelan, *supra* note 48, at 358 ("Statutorily, LLCs need not observe most corporate formalities. Thus, judicial application of the . . . formalities test could impose additional common law requirements to operate with corporate-like formality. . . Judicial modification of the formalities requirement could allow veil piercing when LLC members fail to follow the statutory requirements specifically applicable to LLCs. State statutes require LLCs to maintain ade-

intent of LLC statutes. . .not to burden the entity with heavy formality requirements.¹¹⁹ In recognition of this possibility, several states were prompted to eliminate the formalities test in their LLC statutes.¹²⁰

Lastly, it should be noted that a number of commentators have suggested that courts should not consider whether normal corporate formalities have been met by the LLC, but instead should examine whether members disregard LLC formalities.¹²¹ While this is perhaps a more relevant standard, the reality is that application of such a standard would not be an effective gauge of improper LLC conduct. With very few formalities actually mandated by LLC statutes, LLC members are less likely to run afoul of the rules and cases involving an actual lapse will be few and far between.¹²² The factor would then become more of a hidden pitfall than a credible evaluation of the conduct of the LLC members. As such, the importance of the factor would gradually diminish. As one commentator pointed out, “[I]n the absence of statutory formalities, courts have likely lost an often cited argument for piercing the veil.”¹²³

Notwithstanding the foregoing, the use of formalities as a factor for piercing LLC's has been rejected in both case law and statutes.¹²⁴ For all the reasons cited above, lack of formality should be universally rejected as a factor in LLC piercing cases. Any consideration of this factor by courts in LLC piercing cases would simply act as a distraction from more important elements such as fraud, wrongdoing, and injustice.

quate books and records and an agent for service of process. If company members ignore the formalities imposed by their own operating agreement (e.g. not holding a required periodic meeting), then a failure to follow company formalities may be found. Courts using a formalities test based on the applicable state LLC law may trap unwary companies that function under the sole proprietorship/partnership model and fail to follow formal administrative procedures.”).

119. See Fox, *supra* note 8, at 1172 (“State legislatures. . .intended not to burden LLC's with heavy formality requirements.”); see also Joseph P. Fonfara & Corey R. McCool, *The Wyoming Limited Liability Company: A Viable Alternative to the S Corporation and the Limited Partnership?*, 23 LAND & WATER L. REV. 523, 532 (1988) (stating that “rigid adherence to corporate formalities is not applicable because the LLC has statutorily dispensed with requirements for such formalities”) and Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 378, 446 (1992) (noting that the Wyoming statute requires only a few formalities and concluding that few veil-piercing cases would result).

120. See Cohen-Whelan, *supra* note 48, at 358.

121. See Bahls, *supra* note 9, at 63; see also Cohen-Whelan, *supra* note 48, at 358.

122. See Schwindt, *supra* note 33, at 1561.

123. See *id.*; see also Shaun M. Klein, *Piercing the Veil of the Limited Liability Company, From Sure Bet to Long Shot: Gallinger v. North Star Hospital Mutual Assurance, Ltd.*, 22 J. CORP. L. 131, 138 (1996).

124. See Matheson & Eby, *supra* note 2, at 176.

B. *Alter Ego or Instrumentality*

Much like the adherence to formality factor, the “alter ego” or “instrumentality” factor appears to be tailored more for the corporation than the LLC. Again, the problem involves a distinction between corporations and LLC’s. The alter ego factor was designed to test corporations for appropriate separateness between management and ownership.¹²⁵ As stated previously, this factor was based on the long-standing principle that legitimate corporations must have an appropriate degree of separateness.¹²⁶ If a corporation fails this test, then a piercing of the corporate veil is warranted to prevent abusive uses of the corporate entity, fraud or injustices.

Unlike corporation statutes, sections of the LLC statutes explicitly support flexibility in the LLC management structure.¹²⁷ Some LLC statutes specifically provide for member-management as the default rule, while others make centralized, or manager-managed structure the default.¹²⁸ Either way, the statutes allow the LLC to simply opt out of the default structure for a more preferable management structure.¹²⁹

Notwithstanding the various statutory schemes, LLC’s are more often than not managed by the LLC members.¹³⁰ In addition, generally speaking, members are normally authorized agents and/or managers of LLC’s for the purpose of conducting its affairs.¹³¹ As such, it could be argued that the alter ego factor is usually satisfied for LLC’s.¹³² As one commentator noted, given the statutory authorization of flexible LLC management structures, domination of LLC management by members of the LLC, absent other equitable issues, would appear to be an “inappropriate” factor for the courts to use to pierce the veil to the detriment of the interest holders.¹³³

125. See Fox, *supra* note 8, at 1166.

126. See *id.* at 1163-66.

127. See Huss, *supra* note 2, at 115.

128. *Id.* at 115-16.

129. Fox, *supra* note 8, at 1150-51 (“Another aspect common to most LLC statutes is flexible management. Most statutes contemplate participation in management by all members. The members can agree, however, to a centralized management format at the formation of the LLC.”).

130. See generally Bahls, *supra* note 9, at 62-63.

131. See *id.*

132. *Id.*; see also Stone v. Frederick Hobby Assoc. II, No. CV000181620S, 2001 WL 861822 (Conn. Super. July 10, 2001).

133. Huss, *supra* note 2, at 116.

Thus, application of the alter ego factor to LLC's will often lead to "illogical" results.¹³⁴ By following the letter of the law under the limited liability company statute, you can be left susceptible to personal liability due to a piercing of the LLC's veil. In Illinois, for example, the default rule is that the LLC will be member-managed.¹³⁵ The significance of this is that the majority of LLC's will be operated by their owners, and will therefore be highly susceptible to piercing based on lack of separateness.¹³⁶ If this position is adopted indefinitely by the courts and/or lawmakers, this would have a disastrous chilling effect on LLC formation.¹³⁷

In fact, under the alter ego standard, LLC's may be even more susceptible to piercing than closely held corporations.¹³⁸ Corporations are held somewhat in check by the statutory organization and procedural requirements such as shareholder meetings, minutes, annual reports, etc.¹³⁹ LLC statutes, however, require very few formalities; some states permit LLC's to be formed and run without keeping any records whatsoever.¹⁴⁰

In his article, *Piercing the Veil of Limited Liability Companies*, Eric Fox suggests that the alter ego factor should be applied to centrally managed LLC's but not to member-managed LLC's.¹⁴¹ Fox states that: "[t]he applicability of [the alter ego] factor to LLC's depends largely on the decisions that members make with respect to management alternatives. . . . If the LLC is operated under a centralized management scheme, the separate-entity factor should be given significant consideration."¹⁴² Yet, with regard to member-managed LLC's, "legislatures likely did not intend for member management to infringe on an LLC's ability to maintain limited liability. Therefore, domination of an LLC by its members should not be given significant weight in LLC veil-piercing cases."¹⁴³ This "double" standard for LLC's, how-

134. See Brigham, *supra* note 58, at 76 ("[T]here is a strong argument that this member or shareholder dominance prong of the analysis is illogical when applied to LLCs. This is due to the fact that in Illinois, by statute, the default rule is that the LLC will be member-managed. The significance of this is that the majority of LLCs will be operated by their owners. Thus, by its very nature, the member-managed LLC will be highly susceptible to piercing based on its lack of separateness.").

135. *See id.*

136. *See id.*

137. See Cohen-Whelan, *supra* note 48, at 355.

138. See Schwindt, *supra* note 33, at 1562.

139. *See id.*

140. *See id.*

141. Fox, *supra* note 8, at 1172-73.

142. *Id.*

143. *Id.* at 1174.

ever, would lead to unacceptable results if carried through to its natural conclusion. If centrally-managed LLC's were susceptible to alter ego piercings while member-managed LLC's were exempt, astute business planners would soon rule out any consideration of the centrally-managed LLC as a management structure, for fear of susceptibility to a piercing. This result is contrary to the letter and spirit of the LLC statutes, which explicitly endorse flexibility and freedom of choice in organizing the management structure of an LLC.

C. *Undercapitalization*

Unlike the corporate formality factor and alter ego factor, undercapitalization appears to be directly applicable to LLC's with little or no modification. Importantly, the arguments in support of the undercapitalization factor are as applicable to LLC's as they are to corporations. For example, supporters of the factor argue that flimsy organizations established to escape personal liability should not be tolerated in either the corporate or LLC setting.¹⁴⁴ In addition, commentators assert that undercapitalized firms are more likely to engage in unacceptably risky activities.¹⁴⁵ In the absence of an effective check on the capitalization of firms, they argue that owners will be increasingly willing to engage in risky activities because they have little to lose.¹⁴⁶

Yet undercapitalization has its own set of shortcomings as a piercing factor. First and foremost, raising a barrier in the form of a high standard of capitalization runs the risk of discouraging small business development, which is a major concern for obvious economic reasons. Small business is a vital source of employment, growth, and development in our economy. Therefore, creating such a barrier to small business development should not be contemplated without first establishing that the measure is good public policy. This is especially true when one considers that legislatures have repeatedly created new forms of limited liability entities in part to stimulate investment and growth in small business. As Matheson and Eby point out, "[d]epriving small business owners of their limited liability protection because of their indebtedness runs counter to the purpose of limited liability."¹⁴⁷

Supplying a business perspective, Matheson and Eby raise three important points that show how the undercapitalization standard can be

144. Schwindt, *supra* note 33, at 1563.

145. Bahls, *supra* note 9, at 66.

146. *Id.*

147. Matheson & Eby, *supra* note 2, at 177.

problematic: first, holding a corporation owner liable because the corporation incurs debt in excess of its assets fails to recognize that most businesses, at least initially, are highly leveraged.¹⁴⁸ Outside of the wealthy investor, it is hard to imagine how the modern startup business could be “adequately” capitalized.¹⁴⁹ Second, as stated previously, minimum-capitalization requirements will operate as a bar to new entrants into the market.¹⁵⁰ Considering the importance of small business development to our economy, the high cost of such barriers must be stressed. Such barriers are also contrary to the intent of the legislature, as seen in the LLC statutes.¹⁵¹ Finally, from a purely business-minded perspective, it does not make financial sense to put more capital than necessary into the operation of a modern business.¹⁵² Stockpiling of this sort leads to smaller return on equity and a less successful investment.¹⁵³

Another major problem with undercapitalization is the difficulty in developing a workable standard that can be meaningfully and fairly applied to all shapes and sizes of businesses.¹⁵⁴ One challenge for courts in the corporate veil-piercing arena has been to determine what level of capitalization is sufficient, given the widely divergent needs of businesses and the elusiveness of a standard for gauging the level of risk a particular business proprietor should be willing to accept.¹⁵⁵ Although various theoretical tests for inadequate capitalization have been tossed around, it is unlikely that one test will be able to account for all the different sizes and types of business and the expected and unexpected tort liabilities that are attributable to each particular area of business.¹⁵⁶

Finally, it is important to note that undercapitalization has rarely been found to be sufficient by itself to pierce the veil.¹⁵⁷ In the context of corporate veil piercing cases, most courts have required addi-

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.* at 177-78 (“The repeal of statutory minimum-capitalization requirements for corporations, along with the absence of minimum-capitalization requirements in the modern [LLC] statutes, is strong evidence against inferring a minimum capitalization requirement for [LLC’s]”).

152. Matheson & Eby, *supra* note 2, at 178.

153. *Id.*

154. Huss, *supra* note 2, at 114-15.

155. *See id.*

156. *See id.*

157. *See* Fox, *supra* note 8, at 1162.

tional factors to pierce the veil.¹⁵⁸ Courts apparently have concluded that the policy rationale behind the undercapitalization factor is not strong enough to justify a corporate veil piercing without supporting factors.¹⁵⁹ In light of this fact, the applicability of the other piercing factors becomes significant.

The problems surrounding undercapitalization are enhanced by the fact that the other two main piercing factors (adherence to formalities and alter ego) have serious questions surrounding their applicability to LLC's. Therefore, if the lack of formalities factor and alter ego factor are unavailable to support the piercing of an undercapitalized entity, in the absence of fraud, the entity will not be subject to a piercing.¹⁶⁰ Consequently, when one considers the current state of each of the separate factors, and their interaction as one comprehensive system, the impression you get is that the common law piercing system as it applies to LLC's is patently dysfunctional.

D. *Fraud*

Unlike the previous three factors, fraud is a factor that is equally applicable to LLC's.¹⁶¹ It helps that the policy considerations for preventing fraud in the corporate context apply equally to LLC's.¹⁶² It is in the public interest to disregard the legal fiction of a separate entity, whether that be a corporation or LLC, when those benefiting from that fiction commit fraudulent conduct.¹⁶³ Fraud, however, does not encompass the entire spectrum of conduct that warrants a piercing of the LLC veil in the interest of equity.¹⁶⁴ For example, fraud is more often found where there is a pre-existing relationship between the creditor and the business entity, making fraud more significant for voluntary as opposed to involuntary creditors.¹⁶⁵ The bigger problem for courts and legislators has been how to handle the non-fraudulent cases, such as with an involuntary creditor. This issue will be explored in the following sections.

158. See Fox, *supra* note 8, at 1171, 1174-75 (“[i]f inadequate capitalization is the only factor present in a corporate veil-piercing case, the majority of courts would hold, absent some additional evidence of disrespect for the corporate entity, that the veil should not be pierced”).

159. See *id.* at 1175.

160. See *id.*

161. See Cohen-Whelan, *supra* note 48, at 356.

162. See Fox, *supra* note 8, at 1169.

163. See *id.*

164. See *id.* at 1169-1170.

165. See Cohen-Whelan, *supra* note 48, at 356.

VIII. WHAT LESSONS CAN BE DRAWN FROM EXISTING CASE LAW?

With a handful of early LLC piercing cases from which to draw, this article will briefly survey the landscape of existing case law and attempt to identify common themes and important lessons. For purposes of this article, fourteen cases were selected and scrutinized based on the fact that in each case, to some extent, the court reached the merits of the LLC piercing claim.¹⁶⁶ Several important lessons can be gathered from these cases.

First, it is apparent that the courts have applied the traditional corporate standards for piercing the veil with little mention of the fact that the standards are being applied to an entirely different form of entity.¹⁶⁷ In fact, without looking closely, you would think the courts are simply analyzing the piercing of a corporation.¹⁶⁸ The cases contain no analysis of the distinctions between corporations and limited liability companies. Although a number of the courts cite support for the applicability of the corporate piercing standards to LLC's,¹⁶⁹ they seem to assume a wholesale application and provide little, if any, analysis as to how the corporate standards are to be applied.

To its credit, the Supreme Court of Wyoming recently noted in an LLC piercing case that there are some distinctions between corporations and LLC's that must be taken into consideration. In *Kaycee Land and Livestock v. Flahive*, a decision rendered May 15, 2002, the Court commented: “[c]ertainly, the various factors which would jus-

166. See generally, *Kaycee Land and Livestock v. Flahive*, 46 P.3d 323 (Wyo. 2002); *Nettech Solutions LLC v. Zippark.com*, No. 01 CIV. 2683(SAS), 2001 WL 1111966 (S.D.N.Y. Sept. 20, 2001); *KLM Indus. v. Tylutki*, No. CV980062008S, 2001 WL 1098069 (Conn. Super. Ct. Aug. 23, 2001); *Great Neck Plaza v. Le Peep Rest.*, 37 P.3d 485 (Colo. App. 2001); *Stone v. Frederick Hobby Assoc. II*, No. CV000181620S, 2001 WL 861822 (Conn. Super. Ct. July 10, 2001); *Litchfield Asset Mgmt. v. Howell*, No. CV980076827, 2000 WL 1785122 (Conn. Super. Ct. Nov. 14, 2000); *Hamilton v. AAI Ventures*, 768 So.2d 298 (La. Ct. App. 2000); *Hollowell v. Orleans Reg. Hosp.*, 217 F.3d 379 (5th Cir. 2000); *Trustees of Village of Arden v. Unity Constr. Co.*, No. C.A. 15025, 2000 WL 130627 (Del. Ch. Jan. 26, 2000); *Tom Thumb Food Markets, Inc. v. TLH Prop.*, No. C9-98-1277, 1999 WL 31168 (Minn. Ct. App. Jan. 26, 1999); *In re Webster*, 212 B.R. 1006 (Fla. Bankr. 1997); *Ditty v. Checkrite Ltd.*, 973 F. Supp. 1320 (D. Utah 1997); *Gallinger v. North Star Hosp. Mut. Assur. Ltd.*, 64 F.3d 422 (8th Cir. 1995).

167. See generally, *supra* note 166.

168. See, e.g. *Gallinger*, 64 F.3d at 424, and 427, (referring to the LLC as a “corporate entity,” that was “incorporated in Bermuda”, and seemingly disregarding the fact that the entity in question is an LLC).

169. See, e.g. *Hollowell*, 217 F.3d at 385, n. 7 (stating that “[t]he district court concluded that for alter ego purposes, Louisiana would treat an LLC in the same manner as a corporation”); *Litchfield Asset Mgmt.*, 2000 WL at *1 (noting that “[t]he same theory applies in the case of a limited liability company”); *Ditty*, 973 F.Supp. at 1335 (finding that “most commentators assume that the doctrine [of piercing] applies to limited liability companies”).

tify piercing an LLC veil would not be identical to the corporate situation for the obvious reason that many of the organizational formalities applicable to corporations do not apply to LLC's."¹⁷⁰ Unfortunately, due to an incomplete record, the Court passed on the opportunity to spell out which of the possible factors would be applied to LLC's in Wyoming in the future, finding it "inadvisable" in this case.¹⁷¹ Despite the Court's decision to cut its analysis short, the Court did seemingly open the door to future analysis of the issue of the piercing factors applicable to LLC's. Of all the cases reviewed and cited in this article, this case offered the most hope that courts will be willing to substantively analyze the appropriateness of the piercing standards as applied to LLC's.

In defense of the courts, until recently there has been very little authority in the form of case law or commentary that would support any analysis other than the corporate common law. Thus, courts have had no other choice but to attempt to make the corporate standard "fit" an application to LLC's.

In addition to the courts' deference to the corporate common law, a review of the existing LLC piercing cases shows that courts have become increasingly reliant on the Alter Ego or Instrumentality doctrine.¹⁷² In fact, it has become a rare occasion for a court to address an LLC piercing challenge without application of the alter ego factor.¹⁷³ Starting with the early LLC piercing cases,¹⁷⁴ the trend has continued and can be found in the most recent LLC piercing cases. In *Nettech Solutions LLC v. Zippark.com*, decided September 20, 2001, the court set forth the New York standard, stating: "the corporate veil may be pierced if a corporation is essentially an alter ego of a family or individual."¹⁷⁵ The *Nettech* court then explained that "[i]n order to pierce the corporate veil on a claim for breach of contract, a plaintiff must show (1) the complete domination of the corporation with re-

170. *Kaycee Land and Livestock*, 46 P.3d at 328.

171. *See id.*

172. *See generally*, *Kaycee Land and Livestock*, 46 P.3d 323; *Nettech Solutions LLC*, 2001 WL 1111966; *KLM Indus.*, 2001 WL 1098069; *Great Neck Plaza*, 37 P.3d 485; *Stone*, 2001 WL 861822; *Litchfield Asset Mgmt.*, 2000 WL 1785122.; *Hamilton*, 768 So. 2d 298; *Hollowell*, 217 F.3d 379; *Trustees of Village of Arden*, 2000 WL 130627; *Tom Thumb Food Markets, Inc.*, 1999 WL 31168; *In Re Multimedia Communications Group*, 212 B.R. 1006.; *Ditty*, 973 F. Supp 1320; *Gallinger*, 64 F.3d 422; all of which cite the alter ego/ instrumentality / separateness standard as controlling.

173. As shown by the aforementioned cases, *supra* note 167, where the court actually reaches the merits of the piercing issue, the alter ego / instrumentality factor is the central factor in almost every case.

174. *See, e.g.*, *In re Multimedia Communications Group*, 212 B.R. at 1010; *Ditty*, 973 F.Supp. at 1335-1337.

175. *Nettech Solutions LLC*, 2001 WL at *11.

spect to the transaction at issue, and (2) that such domination was used to commit a fraud or wrong against the aggrieved party.”¹⁷⁶ In *Nettech*, the court denied a motion to dismiss a piercing claim based on facts showing the LLC member exercised complete control over the subject LLC, the LLC had no employees, the LLC was involved in no business other than that derived from the arrangement with the plaintiff, and all of the plaintiff's dealings with the LLC were conducted through the LLC member.¹⁷⁷

In *Great Neck Plaza v. Le Peep Restaurants, LLC*, a Colorado Court of Appeals case decided August 16, 2001, the court applied the alter ego factor in similar fashion, finding that “[t]he corporate entity may be disregarded, and [the] corporate veil may be pierced, if not doing so would defeat public convenience, justify wrong, or protect fraud. Specifically, the veil may be pierced where the subsidiary is merely an alter ego of the principal.”¹⁷⁸ The court then listed ten specific factors upon which it would base its decision to pierce the LLC veil under the alter ego doctrine.¹⁷⁹ Upon doing so, the court found sufficient evidence to support a piercing of the LLC veil, basing its decision on the following: (1) evidence that the individual was president or manager of two judgment debtors and also of the LLC and the holding company; (2) that the individual financed the debtors; (3) that assets were moved “gymnastically” between the debtors, the LLC, and the holding company; (4) that before this garnishment proceeding, no entity besides one debtor was entitled to the profits and income of the LLC; and (4) that at time of this garnishment proceeding, the individual owned all the stock of, and served as president of, the holding company that owned the debtors and the LLC.¹⁸⁰ As shown by these cited facts, *Great Neck Plaza* appears somewhat distinguishable from *Nettech* in that the LLC member in *Great Neck Plaza* was

176. *Id.*

177. *Id.*

178. *Great Neck Plaza*, 37 P.3d at 490.

179. *Id.* (Listing the following factors: “(1) The parent corporation owns all or a majority of the capital stock of the subsidiary. (2) The parent and subsidiary corporations have common directors or officers. (3) The parent corporation finances the subsidiary. (4) The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation. (5) The subsidiary has grossly inadequate capital. (6) The parent corporation pays the salaries or expenses or losses of the subsidiary. (7) The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation. (8) In the papers of the parent corporation, and in the statements of its officers, ‘the subsidiary’ is referred to as such or as a department or division. (9) The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent corporation. (10) The formal legal requirements of the subsidiary as a separate and independent corporation are not observed”).

180. *Id.* at 490.

guilty of more wrongful conduct, including suspicious movement of assets and illicit distribution of LLC funds. Whereas, in *Nettech*, the court relied more on evidence of control and lack of separateness of the LLC from its owner.

The pattern of judicial reliance on the alter ego doctrine was also exhibited in *Stone v. Frederick Hobby Associates II*, a Connecticut case decided July 10, 2001.¹⁸¹ In *Stone*, the court does an effective job of breaking down the Connecticut standard for piercing the corporate veil. The court explained that the Connecticut standard, a variation of the alter ego doctrine, is bifurcated into two separate rules: “[p]iercing the corporate veil, or alternately the alter ego theory, may be proven through the instrumentality rule or the identity rule.”¹⁸² The instrumentality rule, as the court explains, requires proof of three elements:

- (1) [c]ontrol, not mere majority or complete stock control, but complete domination, not only of finances but of policy and business practice in respect to the transaction attacked so that the corporate entity as to this transaction had at the time no separate mind, will or existence of its own; (2) that such control must have been used by the defendant to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or a dishonest or unjust act in contravention of plaintiff’s legal rights; and (3) that the aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of.¹⁸³

The identity rule is applicable to situations where “two corporations or companies are, in reality, controlled as one entity because of common owners, officers, directors, members or shareholders, and because of a lack of observance of corporate or company formalities between the two entities.”¹⁸⁴ In upholding the plaintiff’s motion for prejudgment attachment, the court found probable cause to support a veil piercing under both the instrumentality rule and the identity rule.¹⁸⁵ Similar application of the Connecticut piercing standard is exhibited in two other recent cases, both of which were decided under the alter ego doctrine.¹⁸⁶

As demonstrated by these three examples, as well as the other cases cited, courts facing the issue of piercing an LLC veil have become increasingly dependent upon the alter ego doctrine. This practice is

181. See *Stone*, 2001 WL at *1.

182. *Id.* at *8.

183. *Id.*

184. *Id.* at *9.

185. *Id.* at *10-11.

186. See generally, *KLM Indus.*, 2001 WL at *5; *Litchfield Asset Mgmt.*, 2000 WL at *4-5.

most likely the result of the decreased utility of the corporate formalities factor and the complexity involved in applying the undercapitalization factor.

Another noticeable theme from the cases is that the amount of control possessed and wielded by the LLC owner has played a major role in determining when the LLC veil will be pierced.¹⁸⁷ This result appears to be a natural derivative of the court's constant application of the alter ego doctrine, which normally enlists control as a determining factor. Although the circumstances and terminology used by each court varied somewhat, the message remained the same. . .if the LLC owner exercised too much control over the business, they became vulnerable to a piercing.

The following cases demonstrate the kind of control cited by the courts as grounds for piercing: *Nettech Solutions, LLC v. Zip-Park.com*, (“[t]he facts suggested that [the LLC member] exercised complete dominion and control over all matters concerning [the LLC]”, “[f]urthermore, all of NetTech’s dealings with [the LLC] were through [the LLC member]”)¹⁸⁸; *Great Neck Plaza v. Le Peep Restaurants, LLC*, (control shown by evidence that “individual was president or manager of two judgment debtors and also of limited liability company and holding company,” and “individual owned all stock of, and served as president of, holding company that owned debtors and LLC”)¹⁸⁹; *KLM Industries, Inc. v. Tylutki* (complete control exercised over the management, finances, hiring, and policies of the [LLC])¹⁹⁰; *Stone v. Frederick Hobby Associates II*, (the LLC members exercised “such domination over [the LLC] that in essence, the limited liability company had no mind, will or existence of its own”)¹⁹¹; *Hollowell v. Orleans Regional Hospital LLC*, (dominion and control over the LLC shown by the fact that the individuals held themselves out as the owners and directors of the LLC, they indeed controlled the decisions of the LLC, and they had the ability to receive a \$1.5 million distribution on the eve of [the LLC] shutdown)¹⁹²; *Litchfield Asset Management v. Howell*, (the defendant exercised near complete control in the forma-

187. See generally, *Nettech Solutions LLC*; 2001 WL 1111966; *Great Neck Plaza*, 37 P.3d 485; *KLM Indus.*, 2001 WL 1098069; *Stone*, 2001 WL 861822; *Hollowell*, 217 F.3d 379; *Litchfield Asset Mgmt.*, 2000 WL 1785122.

188. *NetTech Solutions LLC*, 2001 WL at *11.

189. *Great Neck Plaza*, 37 P.3d at 490.

190. *KLM Indus.*, 2001 WL at *5.

191. *Stone*, 2001 WL at *10.

192. See *Hollowell*, 217 F.3d at 387.

tion of the companies, the finances, policy and business practices of the companies)¹⁹³.

These cases demonstrate the current dilemma faced by LLC members and business planners. On the one hand, the state LLC statutes expressly authorize informal management structures with concentrations of power and control in one or more of the members. With many small business owners weary of the burden of corporate formalities and the cumbersome nature of formal corporate management structures, the flexibility offered by the LLC statutes has been a strong selling point. Yet, on the other hand, the judiciary appears ready, willing and able to pierce the veil of such LLC arrangements and find the members personally liable for the debts of the company.

As shown, there are several important themes that can be drawn from the existing case law. First, in the absence of better guidance from courts and commentators, courts will continue to apply the corporate standards for piercing the veil to LLC's as if they were piercing a corporation. In doing so, the courts appear to be perfectly willing to gloss over the fact that they are applying the corporate standards to an entirely different form of entity. Considering the problems with applying the corporate standards to the LLC, as shown above in Section VII, this practice will gradually have a negative impact on LLC's, creating an air of uncertainty as to the limited liability of the entity, and coming in direct conflict with the policy considerations supporting the LLC.

Next, it is clear that courts have become increasingly dependent on the alter ego doctrine in LLC piercing cases. While the alter ego doctrine does provide a standard that is somewhat applicable to LLC's, the standard allows courts to unfairly target LLC's and small businesses and often fails to identify the wrongful conduct that justifies an equitable remedy.

Similarly, the focus on the "control" of the LLC member will make most one and two member LLC's vulnerable to attack. This problem was observed by the court in *Stone v. Frederick Hobby Assoc. II*: "the first element of complete control is certainly present, as would be the case for most limited liability companies having only two members who are also the only two owners and managers."¹⁹⁴ The disparate impact on LLC's caused by the "control" factor is indicative of the problems that have resulted from applying the traditional corporate standards to an entirely different entity.

193. *Litchfield Asset Mgmt.*, 2000 WL at *4.

194. *Stone*, 2001 WL at *10.

Application of the control factor also results in an unmistakable clash of policies. The courts' scrutiny of "control" comes in direct conflict with several of the underlying policies of the LLC (such as flexibility of management structure) that were previously approved by the state legislatures in enacting the LLC statutes. If left uncorrected, the courts' constant scrutiny of control will eventually discourage LLC members from taking advantage of the freedom of management structure expressly provided by the LLC statutes.

IX. THE NEED FOR A NEW STANDARD

To date, the courts have refused to stray very far from the traditional principles of corporate common law in analyzing claims to pierce the veil of LLC's. With the exception of the adherence to corporate formalities factor, courts have generally remained true to the corporate veil piercing standards. This "loyalty" to the traditional standards is unfortunate considering the tremendous advancements that have taken place in business law since the unveiling of the LLC. Tax and business planners have been wise to take notes in pencil considering the constant progression of changes. With that in mind, it seems foolish, even apathetic, to fail to take a hard look at the veil piercing standards. Considering the many distinguishing factors that have set LLC's apart from other business entities, and the work that has gone into their initial adoption and subsequent fine tuning, it is clear that the stage has been set. The time is now right to contemplate the adoption of a new standard that is specially designed and narrowly tailored to the specific traits and underlying policies of the LLC.

A. *Shortcomings of the Corporate Standards*

To understand the need for a new standard for piercing LLC's, one needs to look no further than the existing corporate standards. Despite many years of case law and commentary, our courts have failed to develop and substantially agree upon a meaningful, well-defined standard for piercing the veil of corporations. The rules and rationales for veil piercing have been called "vague and illusory",¹⁹⁵ and the actual judicial application of the standards has been analogized to "lightning" *** rare, severe and unprincipled".¹⁹⁶ Despite being one of the most litigated issues in corporate law, piercing the corporate

195. Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89, 89 (1985); Huss, *supra* note 2, at 109.

196. See Easterbrook & Fischel, *supra* note 195, at 89.

veil remains one of the most misunderstood.¹⁹⁷ The nature of the problem has been summarized as follows:

The question of whether to apply the doctrine of piercing the veil [to LLC's] in the same manner as it is applied to corporations is complicated by the lack of uniformity in the application of the theory to corporations themselves. A description of the various "rules" relating to the doctrine of piercing the veil is difficult to define because of the seemingly random manner in which courts have applied the doctrine. *** [There] is no consensus among commentators and the courts as to which situations the doctrine should be applied.¹⁹⁸

Due to the level of uncertainty and disagreement, the common law has not evolved to the point where one workable standard has emerged. Instead, the piercing doctrine has been obscured to the point where it is now "lost in a fog."¹⁹⁹ In the midst of that fog, courts have been faced with making difficult piercing decisions with very little guidance, sometimes resulting in the court "subjecting business owners to potentially ruinous liabilities because the corporation did not observe irrelevant procedures enacted only to protect shareholders or because owners exercised control over corporations commensurate with their ownership interest."²⁰⁰

Therefore, if in fact the common law standard for piercing the corporate veil is in such disarray, the obvious question is why should we be so determined to apply this mess to LLC's? As one commentator put it, "[the] desultory state of the common law would itself be reason enough for clarification or reform."²⁰¹ Despite all the radical advancements made by the LLC, there is not a great deal of controversy surrounding the entity. Application of the "vague" and "unsettled" corporate piercing standards will effectively import the same frustrations to the LLC. To apply the corporate common law standards to the LLC is the equivalent of knowingly installing a defective auto part in a brand new car. The corporate standards have not worked well in the context of corporations, and they will work even less effectively when applied to LLC's.

197. Schwindt, *supra* note 33, at 1556; (adding that "[j]udicial opinions are 'long on rhetoric and short on reasoning,' using such catch words as 'alter ego,' 'instrumentality,' and 'screen,' followed by little substantive explanation. In addition, courts often fail to distinguish between tort and contract cases despite their requiring obviously different policy considerations. The result is a confusing class of case law that is difficult to apply.") (citations omitted).

198. Huss, *supra* note 2, at 109.

199. See Matheson & Eby, *supra* note 2, at 150.

200. See *id.*

201. See *id.*

B. *The Need for Vagueness?*

One potential barrier to the development of a new standard is the belief that to be effective, piercing law must remain vague.²⁰² This school of thought was derived from the equitable principle that the corporate form should be ignored in cases where the corporation has been used to perpetuate a wrong or injustice.²⁰³ As the thinking goes, in order to insure that the court can provide a remedy for injured parties, piercing law must be kept vague because if made clear, people intent on committing injustices could merely factor their actions around the law.²⁰⁴ While the concerns of intentional circumvention of the law are valid and warrant consideration, perhaps the better solution is flexibility in a standard as opposed to vagueness. With the proper amount of flexibility, judges will have the ability to reach any wrong or injustice. If that flexibility is combined with clear standards, judges will have more guidance on how to apply the law and LLC members will have a better idea of how to lawfully steer clear of a piercing.

C. *LLC's are Unique*

One of the most obvious, yet most important, justifications for creating a new standard for piercing LLC's is that LLC's are significantly different from corporations. In fact, it is many of these differences which have made the LLC one of the fastest growing forms of business entities. As one court noted,

[t]he allure of the limited liability company is its unique ability to bring together in a single business organization the best features of all other business forms – properly structured, its owners obtain both a corporate-styled liability shield and the pass-through tax benefits of a partnership.²⁰⁵

For example, LLC's generally differ from corporations in terms of lack of corporate formalities, decentralized management structure, and partnership pass-through taxation. By combining the best of the corporate and partnership features, LLC's quickly became the entity of choice in the eyes of most business planners. It is also this multi-faceted quality, however, that has led to many of the difficulties in the

202. See Cohen, *supra* note 5, at 445, citing I. Maurice Wormser, *Piercing the Veil of a Corporate Entity*, 12 Colum. L. Rev. 496, 517 (1912); Presser, *supra* note 8, at 1-32.

203. See Wormser, *supra* note 202, at 517, (cited in Cohen, *supra* note 5, at 445)(Wormser was the first person to popularize the term "piercing the veil," believing that the corporate form should be ignored only when a corporation was very obviously used as a means to perpetuate an injustice; thus piercing law had to be kept purposefully vague.).

204. See Cohen, *supra* note 5, at 445.

205. *PB Real Estate, Inc. v. Dem II Prop.*, 719 A.2d 73, 74 (Conn. App. 1998).

application of the veil piercing standards. As Steven C. Bahls points out:

[t]he combination of selected corporate and partnership attributes creates difficulties for courts when deciding whether to apply common-law corporate and partnership doctrines to limited liability companies. The unique combination of these corporate and common-law doctrines makes it inappropriate to apply all corporate common-law rules or all partnership common-law rules without modification.²⁰⁶

As discussed in Section VII, a number of the corporate common law standards, (such as adherence to corporate formalities and the alter ego standard), do not translate well to LLC's. This is partly attributable to some of the partnership-like qualities that LLC's may possess, such as de-centralized management. In addition, application of the traditional common law standards for piercing the corporate veil would fail to consider relevant LLC factors that may indicate when the LLC should be pierced.²⁰⁷ As an example, the traditional corporate piercing standards would not test an LLC to see that the managers and members are operating the LLC in compliance with the applicable LLC statute, the articles of organization, and/or the LLC's operating agreement. Much like the adherence to corporate formalities factor, these issues could provide evidence that the entity was being abused or used for improper purposes.

Therefore, as shown above, the wholesale application of the corporate common law standards to LLC's is hampered by the unique characteristics of LLC's. Considering the well-documented shortcomings of the corporate piercing standards, the measurable differences between corporations and LLC's, and the practical difficulties in applying the corporate standards to LLC's, the pertinent question should not be: "Do we need a new standard?"; but instead "What new or modified standard should we adopt?" Regardless of the final outcome of the debate over LLC piercing standards, "blind faith" in the traditional corporate standards should not be deemed an acceptable means to the end. To have any hope of long term success, the prevailing piercing standards must be the product of a meaningful legislative, judicial and scholarly analysis of the piercing issues as they relate to LLC's.²⁰⁸

206. Bahls, *supra* note 9, at 90-91.

207. See Cohen-Whelan, *supra* note 48, at 354.

208. See *id.*

D. *Early Proposals*

Over the past eight to ten years, commentators have offered several different adaptations of the traditional corporate veil piercing standards in an effort to rectify the apparent problems. Despite their commendable efforts to patch up the system, the proposals fall short of providing an effective, comprehensive system capable of weighing the pertinent factors and assessing fraud, abuse of the LLC, and other forms of wrongful conduct and unfairness.

Submitting his commentary in 1994, Eric Fox's ("Fox") proposal starts by eliminating both the corporate formality factor and the alter ego factor from the equation. Fox concludes that both factors do not translate well to LLC's.²⁰⁹ He then acknowledges that if undercapitalization is the only factor present in a veil-piercing case, most courts would hold the evidence insufficient to pierce. Therefore, Fox advocates the liberalization of the undercapitalization standard, adding that fraud and undercapitalization should be the sole bases for piercing.²¹⁰ Fox justifies this approach with two main arguments: first, in tort cases, requiring adequate capital in LLC's will discourage members from undertaking high-risk ventures and ensure that tort claimants have an avenue of recourse; secondly, in contract cases, adequate capital will eliminate the need for due diligence background checks on the part of potential contract creditors, and eliminate the need for personal assurances – thereby reducing transaction costs.²¹¹

The most significant flaw in the Fox proposal is its over-reliance on undercapitalization. As discussed in Section VII, above, there are serious questions surrounding the application of the undercapitalization factor and courts have rarely found it sufficient by itself to pierce the veil. Intense scrutiny of LLC capitalization fails to value the importance of highly leveraged business start-ups and ignores the barriers that such a standard will present to new business development. In addition, application of undercapitalization alone will fail to sufficiently test for other forms of wrongful conduct such as self-dealing and commingling.

In 1997, Karin Schwindt ("Schwindt") proposed more of a bifurcated system.²¹² According to her proposal, contract cases would be

209. Fox, *supra* note 8, at 1174 (concluding that "[f]irst, failure to follow formalities should not hinder an LLC's veil because the LLC's few statutory formalities are intended to be less burdensome. Second, lack of separateness between members and the entity should not apply to LLC's because they are intended to be managed by members.").

210. *See id.* at 1174-1177.

211. *See id.* at 1176.

212. Schwindt, *supra* note 33, at 1563-1565.

treated differently than tort cases.²¹³ In contract cases, Schwindt suggests that courts look primarily to the alter ego factor or the “disregard of the LLC’s separateness” in deciding whether or not to pierce the LLC veil.²¹⁴ Unlike undercapitalization, which can be pre-screened in a contractual relationship, Schwindt asserts that disregard of separateness is a potential source of misleading and unfair conduct that should weigh heavily in the contract setting.²¹⁵ In tort cases, she proposes that undercapitalization be the most heavily considered factor.²¹⁶ Schwindt argues that adequate capitalization and insurance should be expected and that “[a]llowing the use of the LLC veil to escape possible liabilities would encourage fundamental unfairness and place the burden of recompensing tort victims on society rather than on the entity on which it belongs.”²¹⁷

Swindt’s system, despite its logic, would prove to be overly-restrictive to courts attempting actual application of the system. By pre-designating the factor for each type of case before the facts and circumstances are known, Schwindt’s system would tie the hands of the Court in cases where an alternative standard would be more suitable. For example, in a tort case, an LLC may be sufficiently capitalized, yet lack the degree of separateness required to avoid a piercing under the common law. In addition, much like the Fox proposal, Schwindt’s proposal relies too heavily on undercapitalization in tort cases - a practice that courts have apparently refused to adopt.²¹⁸

In 1998, David Cohen (“Cohen”) proposed a novel step-by-step procedure to analyze the veil-piercing question.²¹⁹ In formulating the list, Cohen garnered support from the underlying principles of limited liability and the doctrines of unconscionability and good faith.²²⁰ Cohen proposed that the Court take the following steps before deciding to pierce the veil of an LLC:

First, courts should determine the size of the LLC, and whether it is traded on secondary markets. The greater the size of an LLC, and the more it is traded on secondary markets, the more limited liability contributes to the efficient running of the LLC (and markets in general). Second, courts should determine whether the creditor was voluntary or involuntary. An involuntary creditor will more than

213. *See id.*

214. *See id.* at 1564-1565.

215. *See id.* at 1564.

216. *See id.* at 1565.

217. Schwindt, *supra* note 33, at 1565.

218. *See Fox, supra* note 8, at 1162 (“undercapitalization infrequently is sufficient by itself to pierce the veil”); *see also, Fox, supra* note 8, at 1158 n.112.

219. Cohen, *supra* note 5, at 490-492.

220. *See id.* at 490.

likely not have consented to his relationship with the LLC, whereas a voluntary creditor could have and should have factored in the risks of contracting with a limited liability entity into their original bargain. Third, courts should determine whether the LLC is member managed or managed by agents. The more use made of agents, the greater importance limited liability and the efficient running of secondary markets assumes in running the firm. Fourth, courts should inquire whether the case at hand involves fraud, misrepresentation, an omission or coercion. If it did, then the creditor probably consented under false pretenses and the LLC bargained in bad faith. Thus, the reasonable expectations of the creditor cannot be fulfilled, by definition. Fifth, courts should inquire whether the LLC was formed with the explicit intent of engaging in risky behavior and being undercapitalized for the likely liabilities. If an LLC was formed with such a purpose, this fact should be extra evidence of the unconscionable behavior of the firm toward involuntary creditors. However, such evidence should not be evidence of unconscionable behavior toward voluntary creditors unless the LLC's purpose was obscured or misrepresented. Sixth, courts should determine whether the members of the LLC failed to respect the separate entity of the LLC by using the LLC's credit to secure loans to members, by using LLC property as if it belonged to members, or by generally failing to hold the firm out as a separate entity. By engaging in such behavior, the LLC members are not fulfilling the promise of the democratic argument - increasing opportunities for risk-taking across a wide socio-economic spectrum - but are abusing a legal technology in order to mislead potential creditors about the member's personal wealth.²²¹

Despite offering a valuable list of important considerations, Cohen's proposal fails to offer a suggestion as to how the six considerations should be wrapped up into one final decision. For example, should some of the steps carry more weight than others? How does the court determine the final outcome of the piercing question? Interestingly, Cohen follows up his proposal by summarily discounting its likelihood of actual application.²²² He concedes that it is unlikely that a legislature or court would adopt a step-by-step test for fear that the existence of a test would encourage courts to pierce and such a test would encourage firms to adjust their actions in such a way as to facilitate abusive behavior while circumventing the events that trigger piercings.²²³

221. *Id.* at 490-491.

222. *See id.* at 491, ("[i]t is unlikely that the legislature or courts in Delaware, or elsewhere for that matter, will provide a step by step test for determining whether or not to pierce an LLC's veil.").

223. Cohen, *supra* note 5, at 491.

E. *Summary*

With the corporate veil piercing standards in such disarray, and their application to LLC's so awkward, there exists a real need for a new standard for piercing the veil of LLC's. While the proposals of Fox, Schwindt and Cohen fall short of providing one comprehensive standard to improve the current system, their efforts provide valuable incite and succeed in moving us closer to our goal.

F. *Goals for a New Standard*

As with any proposed change, the challenge is to propose a system that is better than the current one. In order to attain that goal, we first need to define what qualities a good piercing standard will possess. To start with, the standard should offer a balance between the affected parties. It should: (1) provide guidance to the courts in mapping out the LLC piercing decision; (2) provide creditors with an equitable remedy; and (3) provide LLC members with clear guidance as to the proper way to operate and maintain an LLC.²²⁴ Secondly, the new standard must bring some certainty to this area of the law. That is where marked improvements can be made. In reflecting upon the goals for their proposed standard, Matheson & Eby remarked: the "[a]doption of a single, statutory set of standards for loss of limited liability would bring significant certainty to this area of the law. Courts addressing this issue of piercing for [LLC's] would apply a consistent test, eliminating free-form decisionmaking."²²⁵ Lastly, it is important not to draw too much from comparisons to similar entities. Warren Johnson warns against this: "[a]void the temptation of the metaphor that tries to characterize the LLC as 'like' something that it is not, and instead [***] analyze the LLC as the separate and distinct entity which the state legislatures intended."²²⁶

X. THE MATHESON-EBY MODEL STANDARD

Having critically analyzed some of the early proposals for LLC piercing standards, this article now turns to a model standard proposed in January, 2000. In introducing their model standard, John Matheson and Raymond Eby have done a commendable job of assembling a standard from which commentators can base a discussion

224. See generally Huss, *supra* note 2, at 123-124 (suggesting that a legislative solution to the veil piercing standard problem should include clear guidelines for courts, equitable remedies for creditors, and clear guidelines for LLC operations.).

225. Matheson & Eby, *supra* note 2, at 152.

226. Johnson, *supra* note 83, at 198.

on the necessary elements of a new LLC piercing standard.²²⁷ Matheson and Eby assert that the standard will have universal applicability to corporations as well as other forms of limited liability entities, such as limited liability companies and limited liability partnerships.²²⁸ Without commenting on the feasibility of this bold approach, this article will focus on the application of the standard to LLC's.

A. *Features of the Matheson – Eby Model Standard*

As a condition precedent to an owner's personal liability, the model standard requires that the LLC "be or become" insolvent.²²⁹ If this condition is met, the proposed test identifies three situations in which an LLC member will be found to have waived the statutory limited liability protection.²³⁰ First, an LLC member shall be held to have waived the shield when the member uses the LLC to commit a fraud involving material misrepresentations of the assets of the enterprise.²³¹ In this case, the owner shall be responsible for all of the LLC's debts.

Under the second test, the LLC member waives his/her limited liability when the member causes the LLC to transfer assets or incur obligations to the member or some entity in which the owner has a material interest for less than reasonably equivalent value.²³² The authors describe this transaction as a "conflicted exchange."²³³ Members engaging in such transfers are automatically liable to creditors for the amount transferred in excess of a reasonably equivalent amount.²³⁴ If however, it is shown that the conflicted exchange caused the subsequent insolvency of the LLC, the creditor shall be entitled to recover the entire amount due from the personal assets of the member without regard for the amount of the overpayment.²³⁵

Lastly, if the LLC makes a distribution of assets to a member, in recognition of and as a return on the member's membership interest, and the distribution causes the subsequent insolvency of the LLC, creditors shall be entitled to recover the entire amount due from the

227. Matheson & Eby, *supra* note 2, at 183-187.

228. *Id.* at 151-152.

229. *Id.* at 184.

230. *Id.* at 183-187.

231. *Id.* at 184.

232. Matheson & Eby, *supra* note 2, at 183-184.

233. *Id.* ("Conflicted Exchange means a transfer of money or other property from a Limited Liability Entity to an Owner of that Limited Liability Entity (or to any other organization in which the Owner has a material financial interest) in exchange for services, goods, or other tangible or intangible property of less than reasonably equivalent value.")

234. *Id.* at 183-185.

235. *Id.*

personal assets of the owner.²³⁶ Matheson and Eby call this an “insolvency distribution”.²³⁷ To establish the member’s unlimited liability under this test, the creditor must show that the member, at the time of the insolvency distribution, “knew that the [LLC] was insolvent or should have reasonably foreseen that the insolvency distribution would render [the LLC] insolvent.”²³⁸ If the creditor is only able to prove the occurrence of the insolvency distribution, the LLC member’s liability is limited to the amount of the distribution.²³⁹

B. *General Comments on the Standard*

By far, the most admirable feature of the Matheson–Eby approach is that it turns the focus of the inquiry back on the wrongful conduct of the LLC member. Instead of getting caught up in such issues as corporate formalities, corporate management structures, or the level of capitalization, the central focus of the model standard is the culpability of the LLC member. This design is based on Matheson and Eby’s belief that “[l]ack of honesty in form and in substance should be the sole reason for waiving statutory limited liability.”²⁴⁰ The model standard is designed in such a way that it is the member’s own voluntary acts that lead to the waiver of the member’s limited liability.²⁴¹ The authors note: “[b]y restating the issue in terms of the owner’s waiver rather than the court’s factor balancing, the test more clearly identifies the owner’s own wrongful actions as the source of the owner’s loss of limited-liability protection.”²⁴²

Another positive feature of the model standard is its specific treatment of the conflicted exchange and the insolvency distribution. Both of these tests address intentional misconduct that is meant to thwart the efforts of third party claimants. Unlike the common law standards, the reasoning behind the two standards is clear. In the event an LLC member acts intentionally, in one of these two ways, to wrongfully or unfairly prevent a creditor’s recovery, the entity will be ignored and the member will be held personally liable for the LLC’s debts and obligations.²⁴³ The two tests also clearly specify what types of conduct will amount to a violation and result in a piercing. With the introduction of the conflicted exchange and insolvency distribu-

236. *Id.* at 183-184.

237. Matheson & Eby, *supra* note 2, at 183-184.

238. *Id.* at 184-185.

239. *Id.*

240. *Id.* at 152.

241. *See id.*

242. *Id.* at 181.

243. *See id.* at 152.

tion standards, Matheson and Eby have accomplished their goal of bringing certainty to these particular areas.

One important point about the model standard is that it does not provide a remedy for tort claimants. Matheson and Eby admit that tort claimants have no basis to compel a piercing under the model standard, because their claims “place no reliance on the assets of the business or on the apparent validity of transfers made by the business.”²⁴⁴ The authors leave the issue of protecting tort claimants to the legislatures, pointing out that the legislatures can change the outcome for tort claimants if they determine that public policy so demands.²⁴⁵

What Matheson and Eby fail to mention, however, is that the tort claimant has several “non-piercing” grounds of recovery at his or her disposal. As discussed in Section III, the limited liability shield provided by the LLC will not protect a member from personal liability for their own tortious conduct.²⁴⁶ Liability may also be extended to LLC members through agency principles and in the case of collective tortious conduct or participation in the relevant conduct.²⁴⁷ Therefore, even with no piercing basis provided under the model standard, the only LLC members actually shielded from liability in the case of most tortious conduct are the passive investors who had no direct connection to the claimant’s injuries. This result is consistent with the basic tenets of limited liability. . . encouraging third party capital investment through the protection of the passive investor.²⁴⁸

C. *Fine-tuning the Matheson-Eby Standard*

One foreseeable problem with the Model Standard is its narrow definition of fraud. The standard provides for a waiver of limited liability when an LLC member: “either directly or through representations made through the [LLC], fraudulently misrepresents in any material aspect the assets of the [LLC]”.²⁴⁹ Thus, the standard limits fraud to a showing of a member’s material misrepresentations of the

244. *Id.* at 186.

245. *Id.*

246. Schwindt, *supra* note 33, at 1548.

247. Bahls, *supra* note 9, at 59-60; Schwindt, *supra* note 33, at 1548.

248. See Matheson & Eby, *supra* note 4, at 155-56 (“Granting limited liability to those who contributed capital encouraged investment because people could invest without risking their full personal net worth.” *** “[Outside Investors] are not willing – absent limited liability – to invest in businesses they themselves do not operate or closely monitor. Limited liability continues to enable venture capitalists and casual investors to invest in diverse enterprises without incurring the excessive costs necessary to monitor each enterprise closely.”). Thompson, *supra* note 6 at 7-8.

249. Matheson & Eby, *supra* note 2, at 184.

assets of the enterprise.²⁵⁰ Apparently, Matheson and Eby opted for the narrow definition of fraud in order to avoid opening the floodgates to a wide-array of loosely defined fraud claims. In discussing the proper construction of the fraud factor, the authors state: “[i]n contrast to the open-ended, free-form use of these terms today, however, the focus must be reconstituted in a clear test that requires specific evidence of fraud.”²⁵¹ They later add: “[m]isrepresenting the existence or value of assets on company financial statements may be the most usual behavior of this type.”²⁵² While it may not be a bad idea to rein in the free flow of fraud claims, and it may also be the case that misrepresentations of the company assets are the most common type, the standard as written will fail to provide a remedy to entire categories of defrauded parties.

As discussed in Section III (D), a piercing of the veil of limited liability is intended to be an equitable remedy utilized when a limited liability entity is used by a party to perpetuate a wrong or injustice. Consistent with this philosophy, fraud, in its various forms, has generally been held as sufficient grounds to justify a piercing.²⁵³ Therefore, the traditional message has been that, if you wish to enjoy the benefits of the shield of limited liability, fraud will not be tolerated. For the Model Standard to provide for a piercing only in cases involving fraudulent misrepresentation of entity assets, but not in other cases of fraud, would unfairly preclude recovery for many other defrauded parties. In the case of fraud, the Model Standard casts too small of a net.

Fraud has been defined as “[a]n intentional perversion of truth for the purpose of inducing another in reliance. . . . A false representation. . . which deceives. . . another so that he shall act upon it to his legal injury.”²⁵⁴ The term is defined broadly enough to encompass an assortment of false representations. The types of actions or behaviors that constitute a fraud have generally not been strictly defined by the courts.²⁵⁵ However, certain types of misrepresentations have frequently appeared in piercing cases involving contract claims.²⁵⁶ In addition to misrepresentations concerning the entity’s assets and/or financial status, there are misrepresentations relating to the entity’s performance and misrepresentations that someone besides the entity

250. *See id.* at 182-184.

251. *Id.* at 178.

252. *Id.* at 188.

253. *See Huss, supra* note 2, at 112; Fox, *supra* note 8, at 1156.

254. BLACK’S LAW DICTIONARY 660 (6th ed. 1990).

255. *See Huss, supra* note 2, at 112.

256. *See id.*

will guarantee the debt.²⁵⁷ Fraud has also been found when a corporation was organized merely to protect shareholders from the claims of creditors and when corporate shareholders drain the entity's assets leaving it severely undercapitalized.²⁵⁸ As these examples demonstrate, there are a number of different types of fraud that should trigger a piercing under the Model Standard. Parties who have been defrauded by an LLC member should not be denied recovery because they were not defrauded in the specified manner. To prevent defrauded parties from bearing the loss caused by a fraudulent LLC member, the Model Standard should be revised to provide for piercing in cases where *actual* fraud of any kind is shown.²⁵⁹

D. *Constructive Fraud And Wrongful Conduct*

Critics of the Matheson–Eby Model Standard will undoubtedly argue that the standard is too limited in its protection and that too many injured parties will be left without a remedy. As discussed in Section IX, some critics will argue that the equitable doctrine of piercing the veil must be kept vague to: (1) ensure it can reach any wrong or injustice; and (2) prevent intentional circumvention. As one commentator argued, a set test would “encourage firms to adjust their actions in such a way as to still engage in ‘bad’ behavior but simultaneously to avoid the ‘bright lines’ that would result in piercing.”²⁶⁰ Under the Matheson–Eby standard, even if expanded to cover all cases of actual fraud, the standard will fall short of providing a remedy for non-fraudulent cases resulting in a wrong or injustice. Notably, under the common law standards, courts have generally not required a finding of actual fraud in order to pierce the veil of limited liability.²⁶¹ Therefore, in order to preserve the courts’ ability to provide equitable remedies in cases of wrong and injustice, notwithstanding the absence of actual fraud, I would propose that the liability section of the Model Standard read as follows:

257. *See id.*

258. *See* Cohen-Whelan, *supra* note 48, at 355.

259. Utilizing a standard of actual fraud in piercing cases will not be a novel idea. In Texas, for example, LLC members are held personally liable in cases of actual fraud. *See e.g.* Cohen-Whelan, *supra* note 48, at 353, (citing Tex. Bus. Corp. Act Ann. art. 2.21A(2) (Supp. 1998)).

260. Cohen, *supra* note 5, at 491.

261. *See, e.g., Kaycee Land and Livestock*, 46 P.3d at 328 (quoting Eric Fox, *Piercing the Veil of Limited Liability Companies*, 62 Geo. Wash. L. Rev. 1143, 1169 (1994)) (“Liability on the basis of fraud, however, does not encompass the entire spectrum of cases in which the veil was pierced in the interest of equity.”); *West Concord Conservation Club, Inc. v. Chilson*, 306 N.W.2d 893, 898 n. 3 (Minn. 1981).

LIABILITY OF LIMITED LIABILITY COMPANY OWNERS

- A. Imposition of Liability. Except as expressly provided in the organizational statute of a Limited Liability Company or in other statutes regulating the activities and operations of a Limited Liability Company, or by express agreement of the Members, no Member of a Limited Liability Company shall be personally liable for the debts or obligations of the Limited Liability Company, whether in tort, contract, or otherwise, unless the Limited Liability Company is or becomes insolvent and:²⁶²
1. the Member, either directly or through representations made through the Limited Liability Company, commits actual fraud which causes injury to an individual or entity.
 2. the Member, either directly or through representations made through the Limited Liability Company, is shown through acts or omissions to have committed constructive fraud, *and* he/she is shown to have committed or participated in one or more Wrongful Acts, as defined in this Model Standard, (below).
 3. the Limited Liability Entity participates in a Conflicted Exchange; or
 4. the Limited Liability Entity makes an Insolvency Distribution to the Owner.

As written, Section 2 permits the court to find Members personally liable in cases where the Member has committed constructive fraud, *and* it is shown that the Member committed or participated in one or more wrongful acts as listed in the Model Standard. The goal of the amendment is to preserve the equitable nature of the veil piercing remedy by permitting adequate flexibility, while at the same time constructing a standard with enough certainty to permit lawful LLC members to invest in the entity with the assurances of true limited liability.

Constructive fraud was introduced to the Model Standard to provide injured parties an equitable remedy in cases where they have suffered a wrong or injustice, but are unable to prove actual fraud. Constructive fraud exists “where conduct though not actually fraudulent, has all actual consequences and all legal effects of actual fraud.”²⁶³ The term has been defined as an “unintentional deception or misrepresentation that causes injury to another”²⁶⁴, and as:

. . . any act, statement or omission which amounts to positive fraud or which is construed as fraud by the courts because of its detrimental effect upon public interests and public or private confidences. It requires neither actual dishonesty nor intent to deceive, being a breach of a legal or equitable duty which, irrespective of the moral

262. See Matheson & Eby, *supra* note 2, at 184.

263. Klein, *supra* note 123, at 145, (citing BLACK’S LAW DICTIONARY 314 (6th ed. 1990)).

264. BLACK’S LAW DICTIONARY 671 (7th ed. 1999) (defining “fraud”).

guilt of the wrongdoer, the law declares fraudulent because of its tendency to deceive others.²⁶⁵

Generally speaking, constructive fraud differs from actual fraud in that proof of intent is not necessary to establish a claim of constructive fraud.²⁶⁶ Courts have cited constructive fraud as sufficient grounds for piercing the corporate veil when evidence of actual fraud is not present.²⁶⁷

Constructive fraud has commonly been applied in cases where the parties have less than an arms-length relationship, usually involving a duty between the parties.²⁶⁸ In this context, constructive fraud has been defined as “the breach of a legal or equitable duty which the law declares fraudulent because it violates a fiduciary relationship.”²⁶⁹

In 1988, in *Drilcon, Inc. v. Roil Energy Corp., Inc.*, the Montana Supreme Court noted a line of Montana cases supporting the theory that there must be a breach of a fiduciary relationship in an action for constructive fraud.²⁷⁰ One such case held: “Constructive fraud is a breach of fiduciary duty. (Citations omitted). If there is no fiduciary duty in the first place, constructive fraud will not lie.”²⁷¹ Despite the noted cases, the *Drilcon* court followed an alternative line of cases recognizing an exception to the fiduciary duty requirement. The exception provides that under “special circumstances”, neither a confidential relationship nor a fiduciary relationship is needed to find constructive fraud.²⁷² As defined by the *Drilcon* court, special circumstances exist whenever “[a] party, by his words or conduct creates a false impression concerning serious impairments or other important matters and subsequently fails to disclose relevant factors.”²⁷³

265. *Tome Engenharia E. Transportes, Ltd. v. Malki*, No. 94 C 7427, 1996 WL 172286, at *6 (N.D.Ill. Apr. 11, 1996); (citing *Index Futures Group, Inc. v. Ross*, 557 NE.2d 344, 349 (Ill.App. Ct. 1990); *See also*, *Muhl v. Tiber Holding Corp.*, 18 F.Supp.2d 514 (E.D.Pa. 1998) (citing *Southern Indus., Inc. v. Jeremias*, 66 A.D.2d 178, 182 (N.Y. App. Div. 1978)(defining constructive fraud as a “breach of a duty which, irrespective of moral guilt and intent, the law declares fraudulent because of its tendency to deceive, to violate a confidence or to injure public or private interests which the law deems worthy of special protection.”).

266. *See Muhl.*, 18 F. Supp.2d at 518.

267. *See, e.g.* *West Concord Conservation Club, Inc. v. Chilson*, 306 N.W.2d 893, 898 n.3 (Minn. 1979); *Miller & Schroeder, Inc. v. Gearman*, 413 N.W.2d 194, 196 (Minn. Ct. App. 1987).

268. *See, e.g.*, *Bado Equipment Co., Inc., v. Bethlehem Steel Corp.*, 814 S.W.2d 464, 475 (Texas 1991); *Carnes v. Meador*, 533 S.W.2d 365, 370 (Texas 1975); *Archer v. Griffith*, 390 S.W.2d 735, 740 (Texas 1964).

269. *See Bado Equipment Co.*, 814 S.W.2d at 475 (Texas 1991).

270. *Drilcon, Inc. v. Roil Energy Corp., Inc.*, 749 P.2d 1058, 1061 (Mont. 1988).

271. *Rowland v. Klies*, 726 P.2d 310, 316 (Mont. 1986)(quoting *Morse v. Espeland*, 696 P.2d 428, 430 (Mont. 1985).

272. *Drilcon*, 749 P.2d at 1061.

273. *Id.* at 1061-1062 (finding that special circumstances existed based on evidence of an improperly perfected corporate entity, failure to disclose corporate imperfections to creditors, fail-

Similar to the Montana special circumstances requirement, some courts and commentators have suggested that while constructive fraud alone should be insufficient to pierce the veil, constructive fraud in combination with other elements of wrongdoing should be deemed sufficient. Two such commentators, critical of the application of constructive fraud by itself, noted:

At least two cases. . . which used constructive fraud as the basis for disregarding the corporate entity did so in combination with other elements. *Tigrett v. Pointer* involved an undercapitalized corporation, breach of the trust fund doctrine, and a loan by the dominant shareholder. *Cupples Coiled Pipe, Inc. v. Esco Supply Co.* was a products liability case which also involved inadequate capitalization and loose financial arrangements between the parent and the subsidiary. The existence of factors other than constructive fraud, coupled with strong public policies in favor of predictability and stability, support these holdings.²⁷⁴

Therefore, while constructive fraud has been criticized by some as too broad or tenuous a basis to justify a piercing by itself, the combination of constructive fraud and other elements of wrongdoing provide adequate assurances that a potential veil piercing would be justifiable.

Constructive fraud will give courts more ability to provide the equitable remedy of piercing in cases where parties have suffered a wrong or injustice at the hands of an LLC member. The installation of this factor should also satisfy critics who would otherwise argue that the Matheson-Eby standard is too restrictive on courts - since it prevents courts from providing a remedy in the absence of actual fraud.

Admittedly, authorizing piercing on the basis of constructive fraud alone could tip the scales unfairly against members of LLC's. With no showing of intent required, a case of constructive fraud will generally be too tenuous on its own to justify a piercing. For one thing, constructive fraud, as a concept, has "fuzzier edges" and is less susceptible to precise definition.²⁷⁵ As such, allowing courts to pierce the veil of LLC's solely on the basis of constructive fraud runs the risk of opening the floodgates to a wide range of piercing scenarios with little proof of wrongdoing, which would amount to a reversion to the dreadful vagueness and uncertainty of the corporate common law.

ure to disclose true financial condition of personal guarantor, and failure to disclose that guarantor was not a corporate officer.)

274. Michael J. Shearn and Peter M. Koelling, *Castleberry v. Branscum: A Divided Texas Supreme Court Increases Shareholder Liability For Corporate Contractual Obligations*, 19 St. Mary's L.J. 245, 263 - 264 (1987), (citing *Tigrett v. Pointer*, 580 S.W.2d 375, 382-83 (Tex. App. 1978); *Cupples Coiled Pipe, Inc. v. Esco Supply Co.* 591 S.W.2d 615, 617 (Tex. App. 1979)).

275. *Rosen v. Matthews Const. Co., Inc.*, 777 S.W.2d 434, 437 (Tex. App. 1989).

Yet, rather than discard the factor altogether, the better course is to require additional proof of wrongdoing in conjunction with constructive fraud to assure the court that the case involves sufficient wrongdoing or injustice to justify a piercing. This approach draws support from cases such as *Drilcon*, *Tigrett*, and *Cupples Coiled Pipe, Inc.*, above, wherein constructive fraud was found sufficient when combined with "special circumstances" or other wrongful factors. Under the suggested revisions to the Model Standard, the second layer of proof requires a showing of one or more of the traditional "bad" or "wrongful" acts which have traditionally been considered strong indicia of abuse of the entity.

E. Proof of Wrongful Conduct

In order to assure itself of a worthy case for piercing the LLC veil, in addition to a showing of constructive fraud, courts applying the Model Standard shall require proof of one or more of the following:

(1) Commingling - whether members and managers fail to keep business funds and accounts separate from funds and accounts of members, (or) whether members fail to keep their personal books and financial accounts and records separate from the LLC books.²⁷⁶

(2) Siphoning of Funds - whether the manager or majority member has siphoned funds from the LLC in violation of the articles of organization, the operating agreement, or the state's LLC statute;²⁷⁷

(3) Gross Undercapitalization - at the time of its formation, *or* at the time of the litigated transaction or occurrence, whether the LLC was grossly undercapitalized, rendering the business unable to satisfy the reasonably anticipated debts and expenses of the LLC incurred in the ordinary course of business;²⁷⁸

(4) Public Notice of The LLC - whether the members fail to hold the business out as a separate legal entity;²⁷⁹

(5) The Members Usurp Power - whether the members make decisions for the LLC, thereby usurping the power of the managers, in direct contravention of the articles of organization and/or operating agreement;²⁸⁰

(6) Disrespect of the Separate Legal Entity - whether the members acted in such a way as to fail to respect the separate legal existence of the LLC, as shown by such acts as using LLC credit to secure

276. See Cohen, *supra* note 5, at 458; Bahls, *supra* note 9, at 64.

277. See Klein, *supra* note 123, at 136-138.

278. See Cohen, *supra* note 5, at 458; Bahls, *supra* note 9, at 64.

279. See Cohen, *supra* note 5, at 458; Bahls, *supra* note 9, at 64-65.

280. See Cohen, *supra* note 5, at 458; Bahls, *supra* note 9, at 65.

personal loans, distributing LLC earnings to members through non-authorized means, members using LLC property as if it were their own, or other usage of the LLC by members for personal transactions;²⁸¹

(7) Improper Purpose of Formation - whether the LLC was organized with the purpose of avoiding contractual liabilities, or circumventing regulatory statutes or common law duties.²⁸²

(8) Breach of Fiduciary Relationship - whether the members' acts constituted a breach of a legal or equitable duty owed to the injured party, thereby violating a fiduciary relationship.

F. *General Comments on the Wrongful Conduct Factors*

These eight "wrongful" acts are each indicative of abusive behavior in connection with the LLC. They were selected based on the following two characteristics: (1) they each require a showing of facts that are probative of wrongful conduct and/or abuses of the entity; and (2) they are susceptible to bright line tests, allowing for a sense of certainty and clear definition of the wrongful conduct. With gradual refinement, eventually the list will serve as an effective gauge of LLC activity, capable of identifying abusive conduct.

Several factors traditionally used to evaluate corporations in piercing cases were intentionally omitted from the wrongful conduct list, including: (1) lack of corporate formalities;²⁸³ (2) nonfunctioning officers and directors other than shareholders;²⁸⁴ and (3) absence of corporate records.²⁸⁵ Unlike the eight factors chosen, these factors are more probative of corporate neglect than intentional misuse of the entity. In addition, the factors are tailored to the characteristics of the corporation and do not translate well to the unique characteristics of the LLC.

Factor (8) pertains to cases where the constructive fraud involves the breach of a fiduciary relationship. Drawing from traditional principles of constructive fraud, which required a fiduciary relationship,²⁸⁶ the injured party may prove that the parties had less than an arm's-length relationship - one involving a fiduciary relationship and/or legal duty. If such a fiduciary relationship is proven, no further wrongful acts need be shown to justify the piercing. The breach of the legal or

281. See Cohen, *supra* note 5, at 458; Bahls, *supra* note 9, at 65.

282. See Bahls, *supra* note 9, at 66.

283. See Cohen, *supra* note 5, at 458; Klein, *supra* note 123, at 136-138.

284. See Klein, *supra* note 123, at 136-138.

285. See *id.*

286. See, e.g., *Bado Equipment Co., Inc.*, 814 S.W.2d at 475.

equitable duty owed to the injured party, in conjunction with the constructive fraud, provides adequate justification for the piercing.

With regard to factor (3), gross undercapitalization, a few comments are in order. First, to be considered wrongful conduct, this factor shall require a higher degree or "gross" case of undercapitalization to ensure the culpability necessary to justify a piercing. The modifier "gross" is included in order to necessitate the showing of a "glaring" or "flagrant" case of undercapitalization, something more than the plain vanilla case of inadequate capitalization.

The heightened standard of "gross" undercapitalization has been invoked by courts as a way of further reinforcing the case for piercing the veil, in situations where the court may have otherwise found mere undercapitalization insufficient.²⁸⁷ In addition, gross undercapitalization has been utilized as a means of discouraging frequent adjudication of undercapitalization issues.²⁸⁸ By adopting the "gross" standard, these courts have essentially raised the bar for parties seeking to pierce the veil on the basis of inadequate capitalization.

The basic standard of inadequate capitalization tests whether a corporation has sufficient capital to cover its reasonably anticipated liabilities as measured by the nature and magnitude of its undertaking, the risks attendant to the particular enterprise and the normal operating costs associated with the business.²⁸⁹ In contrast to the basic standard, gross undercapitalization requires proof of: "[a]n obvious inadequacy of capital;" "no attempt to provide adequate capitalization;" or "capital trifling compared with the business to be done and the risks of loss."²⁹⁰ Arizona courts, for example, require "more than mere unprofitability for an enterprise to be considered undercapitalized, the amount of capital must be 'illusory or trifling.'"²⁹¹ As shown, gross undercapitalization necessitates an exaggerated showing of capital deficiency that leaves little doubt that an abuse of the entity has occurred.

In addition to the degree of undercapitalization required, it is also important to consider the timing of the assessment. There are two points in time in which the LLC must be judged. First, a piercing shall be permitted if the LLC is grossly undercapitalized at the time of its

287. See e.g., *Keams v. Tempe Technical Inst., Inc.*, 993 F.Supp. 714, 724 (D. Ariz. 1997); Harvey Gelb, *CERCLA Versus Corporate Limited Liability*, 48 U. KAN. L. REV. 111, 122 (1999).

288. See Gelb, *supra* note 287, at 122.

289. See *Stirling-Wanner v. Pocket Novels, Inc.*, 879 P.2d 210, 213 (Or. Ct. App. 1994).

290. Harvey Gelb, *Piercing The Corporate Veil – The Undercapitalization Factor*, 59 CHI.-KENT L. REV. 1, 14 (1982).

291. *Keams*, 993 F. Supp. at 724 (citing *Norris Chemical Co. v. Ingram*, 679 P.2d 567, 570 (Ariz. Ct. App. 1984)).

formation.²⁹² Piercing under these circumstances is necessary to protect the reasonable expectations of parties dealing with the LLC, because creditors and other individuals (including consumers and other business persons), “do not expect LLC’s to be grossly undercapitalized at the date of formation.”²⁹³ Thus, assessment of the LLC at formation is aimed at preventing business planners and LLC members from “deliberately or recklessly” capitalizing an LLC so inadequately that they violate the reasonable expectations of those dealing with the business,²⁹⁴ while at the same time discouraging the temptation of inadequately capitalized firms to engage in unacceptably risky activities.²⁹⁵

While it is apparent that the LLC’s capitalization should be judged at the time of formation, it seems equally apparent that the current circumstances of the LLC, existing at the time of the triggering event, incident and/or injury, must also be assessed.²⁹⁶ Courts have recognized that “the obligation to provide adequate capital begins with incorporation and is a continuing obligation thereafter. . . during the corporation’s operations.”²⁹⁷ This is the case because the financial condition of the LLC may have changed drastically, along with the LLC ownership, over the life of the LLC. Indeed, the LLC may have gone through multiple cycles of adequate capitalization and gross undercapitalization prior to the date it first encountered the relevant creditor or third party. In the interim period of time, a grossly undercapitalized firm may have received an ample capital infusion, while a generously capitalized entity may have been subjected to reckless siphoning of funds to the point of undercapitalization. As one commentator noted:

The determination of the adequacy of the level of assets provided for a corporation should not be frozen arbitrarily as suggested by courts which stress only capitalization at the inception of the corporation. Certainly, for example, at some point in time after funds fall below the level deemed appropriate for providing the requisite degree of creditor protection, such deficiency should afford a basis for

292. See *Stirling-Wanner*, 879 P.2d at 213 (noting that the sufficiency of capital is determined at the time a corporation is formed and at the beginning of its operation); *Gardner v. First Escrow Corp.*, 696 P.2d 1172, 1178 (1985).

293. See *Bahls*, *supra* note 9, at 66.

294. See *id.*

295. See *id.*

296. This view has been embraced by several courts and commentators. See, e.g., *Dewitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.*, 540 F.2d 681, 686 (4th Cir. 1976) (citing *James R. Gillespie, The Thin Corporate Line: Loss of Limited Liability Protection*, 45 N.D.L.Rev. 363 377-8 (1969)); *Dix, Adequate Risk Capital*, 52 Nw. U. L. Rev. 478, 494 (1958).

297. *Dewitt Truck Brokers, Inc.*, 540 F.2d at 686.

disregarding the corporate entity. So too it should be recognized that an initially inadequate level of assets can be cured.²⁹⁸

For the reasons stated here, courts should be permitted to consider the current level of capitalization of the entity, along with the levels for a reasonable period of time leading up to the triggering event (such as the preceding 12 months) in order to decide whether the current LLC members were operating the LLC under conditions of gross undercapitalization.

G. *Legislative Exceptions to Limited Liability, (e.g. Products Liability)*

Assuming for a moment that a version of the Matheson–Eby standard were adopted, there may be those who evaluate the new system and conclude that there are certain groups that are not sufficiently protected by the standard. Legislatures and courts in some states have already limited the usage of LLC's to prevent abuse and inequity under certain circumstances, as with the Ohio Supreme Court rule that attorneys practicing in LLC's must maintain a specified level of malpractice insurance in order to obtain limited liability.²⁹⁹

One example of an area where special attention may be necessary is products liability. Under our system of jurisprudence, special protections, including strict liability, have been carved out for victims of manufacturing and/or product defects. The rule of strict liability in defective product cases causes a person who sells a product “in a defective condition [un]reasonably dangerous to the user or consumer” to be liable to the ultimate user or consumer for any harm caused by use of the product if “(a) the seller is engaged in the business of selling such a product, and (b) it is expected to and does reach the user or consumer without substantial change in the condition in which it is sold.”³⁰⁰ Over many years of observation and discussion, these protections were deemed necessary to protect the interests of injured consumers.

The purpose of strict tort liability is “to insure that the costs of injuries resulting from defective products are borne by the manufacturers that put such products on the market rather than by the injured persons who are powerless to protect themselves.”³⁰¹ In his famous con-

298. See Gelb, *supra* note 290, at 18.

299. See Rule III of the Ohio Supreme Court Rules for the Government of the Bar, 2001 ed.

300. Keener v. Dayton Electric Manufacturing Co., 445 S.W.2d 362, 364 (Mo. 1969) (adopting the rule of strict liability as defined in the Restatement (Second) of Torts § 402(A)).

301. Ray v. Alad Corp., 560 P.2d 3, 8 (Calif. 1977) (*citing* Greenman v. Yuba Power Products, Inc. 377 P.2d 897, 901 (Calif. 1963)).

ccurring opinion in *Escola v. Coca Cola Bottling Co.*, Justice Traynor described some of the key justifications for the strict liability doctrine:

Even if there is no negligence, ***, public policy demands that responsibility be fixed wherever it will most effectively reduce the hazards to life and health inherent in defective products that reach the market. It is evident that the manufacturer can anticipate some hazards and guard against the recurrence of others, as the public cannot. Those who suffer injury from defective products are unprepared to meet its consequences. The cost of an injury and the loss of time or health may be an overwhelming misfortune to the person injured, and a needless one, for the risk of injury can be insured by the manufacturer and distributed among the public as a cost of doing business. It is to the public interest to discourage the marketing of products having defects that are a menace to the public. If such products nevertheless find their way into the market it is to the public interest to place the responsibility for whatever injury they may cause upon the manufacturer, who, even if he is not negligent in the manufacture of the product, is responsible for its reaching the market. However intermittently such injuries may occur and however haphazardly they may strike, the risk of their occurrence is a constant risk and a general one. Against such a risk there should be general and constant protection and the manufacturer is best situated to afford such protection.³⁰²

Thus, the “paramount policy” being promoted by strict liability “is the protection of otherwise defenseless victims of manufacturing defects and the spreading throughout society of the cost of compensating them.”³⁰³

In addition to strict liability, the area of products liability also offers special protections to injured parties in the way of successor liability. Under this doctrine, if a defined set of circumstances are present, the successor of a manufacturer shall assume strict tort liability for defects in a product manufactured and distributed by the entity from which the business was acquired.³⁰⁴ The justifications for imposing strict liability upon a successor to a manufacturer under these circumstances have been summarized as:

- (1) the virtual destruction of the plaintiff’s remedies against the original manufacturer caused by the successor’s acquisition of the business, (2) the successor’s ability to assume the original manufacturer’s risk-spreading rule, and (3) the fairness of requiring the successor to assume a responsibility for defective products that was a burden necessarily attached to the original

302. *Escola v. Coca Cola Bottling Co.*, 150 P.2d 436, 440-41 (Calif. 1944).

303. *Ray*, 560 P.2d at 8.

304. *See id.* at 10-11.

manufacturer's good will being enjoyed by the successor in the continued operation of the business.³⁰⁵

As shown by the previous examples, special protections have been fashioned for those injured by defective products. Behind these rules of liability, lie strong issues of public policy that have provided the foundation upon which the rules were based.

Similarly, it could be argued that consumers injured by defective products should not be denied recovery because the most culpable party is shielded by the limited liability of an LLC. Many of the same arguments used to justify strict liability, such as deterrence and risk-shifting, could be used to justify a piercing of the LLC veil. For these reasons, legislatures may find it necessary to consider special piercing rules for LLC's involved in the production, distribution, and sale of consumer or commercial products. For example, to provide for consumer protection in the case of defective products, a state may make the limited liability of an LLC engaged in consumer sales conditioned upon mandatory insurance or minimal levels of capitalization. To minimize the barrier-effect on small business start-ups, such requirements could be limited to those entities with a fixed amount of gross sales – such as \$ 1,000,000.00 per fiscal year. Linking limited liability to insurance and/or minimal capitalization would, in effect, shift the risk of loss to those parties in the best position to prevent injuries, the manufacturers, and make consumer protection a cost of doing business.

As shown by the foregoing products liability example, certain circumstances may warrant the fashioning of special rules for piercing the veil of LLC's. Before exploring such exceptional rules, however, legislatures should test for strong public policy favoring the exceptions. Otherwise, limited liability will eventually become so hampered by exceptions it will offer nothing more than an empty promise.

XI. CONCLUSION

By enacting the LLC statutes, state legislatures in all 50 states have placed their stamp of approval on this new form of business entity. By statute, LLC's have been authorized to conduct business with very little formality and simple, customized management structures. The practical benefits of the LLC have quickly made it the entity-of-choice for many new business start-ups.³⁰⁶ Unfortunately, the application of traditional corporate veil-piercing standards to LLC's has called into

305. *Id.* at 8-9.

306. As an example of the rapid growth in the relative popularity of the LLC, (versus the corporation), according to the records of the Ohio Secretary of State, J. Kenneth Blackwell,

question the reliability of the limited liability protection offered by the entity.

A better standard for piercing the veil of LLC's is currently within our grasp. The alternative is not a good one. Continuing to mechanically apply corporate piercing doctrines to LLC's will lead to unacceptable outcomes. The same vision and forward-thinking that led to the enactment of the LLC should now be concentrated on the development of a piercing standard specially designed to fit the unique characteristics of the LLC. The Matheson-Eby Model Standard offers an excellent starting point for the discussion. In carving out the Model Standard, Matheson and Eby show how a better standard can be designed through analysis of the interests and principles that are applicable to the unique circumstances surrounding the LLC. For a new standard to be effective, the proper balance must be struck between providing honest business owners security in knowing that their limited liability shield is not in jeopardy, while preventing fraudulent or unscrupulous owners from hiding behind the shield of limited liability.

With a few modifications, the Matheson-Eby Model Standard would be better-equipped to preserve equity and combat abusive behavior. A broader definition of fraud, for example, would allow courts to remedy more types of fraudulent misconduct. In addition, the incorporation of the constructive fraud concept, in conjunction with a finite list of wrongful acts, would strike the right balance between equity and guidance.

Love or hate these particular proposals, it is time we rolled up our sleeves and got to work on a better standard. Only through analysis and discussion will we know whether a better standard is attainable.

Just because we cannot see clearly the end of the road, that is no reason for not setting out on the essential journey. On the contrary, great change dominates the world, and unless we move with change we will become its victims.

Robert F. Kennedy, 1964³⁰⁷

25,067 domestic LLC's were filed in Ohio in 2002, as compared to the 18,483 domestic corporations filed in Ohio during the same period.

307. Shrager & Frost, *supra* note 1, at 38 (quoting Robert F. Kennedy's Farewell Statement, Warsaw, Poland, reported in the New York Times, July 2, 1964).